IFB206: Roth vs 401k and Investing With a Margin of Safety

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[00:00:00] **Dave:** All right, folks. Welcome to Investing for Beginners podcast. Tonight we have episode 206 tonight. We have three great listener questions that we're going to answer. So without any further ado, I'm going to go ahead and read the first question.

So this is a bit long. So bear with me for just a moment. So I have hello, Andrew. I am a 24-year-old who has just started becoming interested in investing over the last two months. Your podcast has helped me learn so much and continues to add to my curiosity. I have just finished my first year working.

I realized I should start caring more about what I save. I recently told my dad that I wanted to add $5,000 of savings and start contributing an additional $200 a month to buy stock in a Roth IRA account. He had me open when I was 18 with $700. I've never touched it to a month ago. He immediately told me I should not do that.

And I never listened to him. He says that I am wasting the tax advantages offered by putting non-taxed money from my paycheck into my 401k account. Instead, he told me to buy stock through that account. I've been looking into it, and my company 401k only offers different choices of funds, not individual stocks.

What are my best options for the accounts to use? I have quickly found myself paralyzed about which road to take the same way I was before I learned how investing works and the concepts I never fully understood. Should we continue to contribute to our 401k's only investing in funds that reaching the maximum country contributions, then worry about adding to the outside IRA in later years, this seems easy and safe, but the concept of dividends has been itching to get.

I like to start collecting stock in a portfolio to begin the second form of income I can use in 30 to 35 years. Do you think investing $5,000 in a market with an additional $200 a month is a better option than increasing

our 401k contributions would continue our 10% in a 401k? Thank you, Eric. Andrew, what are your thoughts on Eric's various do question and kind of comical,

[00:02:00] **Andrew:** It is comical, and I'm glad he's itching for dividends because I'm right there with you, and you are in the right camp.

So a couple of things to keep in mind. Number one. If you're doing a 401k, you are going to get dividends. Most likely, as long as you're picking a fund that has stocks, now you're going to get dividends. So don't worry about that. Number two, whether you pick a 401k or an IRA, in this case, he talked about the Roth IRA.

So if you're picking a Roth IRA, regardless of which IRA you pick, you're still getting tax advantages. The difference is that you have tax advantages. Now, or you have tax advantages in the future. So with a Roth, you pay the taxes now. So it's true. You don't get a tax advantage now, but you get the advantage that all of your gains are never taxed, whereas a regular 401k, you get the tax advantage now, but when you take out at the end, you're going to pay capital gains tax on those.

So you can't evade the taxman. With everything, unfortunately, you're going to have to pick your poison. And so that's really what you want to do, relates to that. And, you get into all sorts of discussions of what's my tax rate today. What's it going to be like when I retire, whether the tax rates for the country are going to be when I retire, we could go on and on; it doesn't matter.

I'll tell you what I did when I first started my career when I was 20. So long ago, I remember when he was three, we'll call it 23. So a good rule of thumb. One I've heard circle around a lot, and I really prescribed to it was number one. If the company that you work for offers you a 401k match.

Take full advantage of that match 100% because if you put in a dollar and the company gives you a dollar, that's a 100% return on your money. You're not going to get that in the stock market. You could get in the stock market, but that could also go away really quickly too. So if you want something that's reliable and safe, you can't go anywhere better than that.

So do that first. What I did once I reached my match. Was I took, and I wanted to max out my Roth. And that was because I saw the value in allowing my basically capital gains to all to be, to not have to deal with capital gains in the future to not have to deal with, I was okay with paying the taxes now on my income in order to not pay capital gains tax in the future.

And we just recently episode on capital gains. We went a little bit into the weeds on that. So that might be valuable to listen to as well. Keep that in mind; if that makes sense for you, then you max out the IRA. Then after that, you can always go back after you've maxed out the IRA. You can go back and add some more to your 401k until you max that out too.

And then finally, if you get to that point where you've maxed the 401k you've max IRA, then you can go into a regular brokerage account, and you'll have to pay taxes on that. I get the wanting to pick stocks for yourself. Trust me on the all they're all about the Roth IRA; when it comes to a match, you really can't be the match.

And then when it comes to the question between a 401k or a Roth, which one do I put more money towards, it really comes down to you. And how you feel about it. When you want to pay taxes and what part of that is, it is of most value to you, and that's what it comes down to, I think.

[00:05:27] **Dave:** I agree; it definitely comes down to that. And. The idea of the tax advantage accounts. What Andrew was saying is really the whole crux of the idea is you either pay Uncle Sam now, or you paying Uncle Sam later. And the classic advice or rule of thumb, the younger you are, the more. Financial advisors recommend starting with a Roth.

So Eric had mentioned that he was 24, 25. And so, that would be the classic time to start a Roth IRA to take advantage of that. A lot of people don't really understand this, too; with your 401k, you had the option of choosing a Roth as well as a traditional one. So you could choose both.

You could shoot, you could split them on if you want, or you could just choose a Roth with your IRA as well, or I'm sorry with your 401k. So you have additional options. So the 401k is not just a static option. You have the choice of choosing a 401k. You have a choice of choosing a Roth or traditional, sorry.

I'm mixing up all my metaphors today. So you have other options. And as far as the questions about the tax rates now and in the future, none of us know what the future is going to hold. And I think you need to try to figure out what's going to work best for you now and worry about what's going to happen 30 or 40 years from now.

When 30 or 40 years happen because we very well could be paying, we all could be paying 90% tax rates, or we could all not be paying taxes at all, who knows. And so I think trying to hedge your bets now versus Dan, especially when you're younger like Eric, is you have so much time for all that money to accumulate.

With not having to worry about taxes 30 or 40 years from now, then going the other route and worrying about what the tax rate's going to be when you start to take your required minimum withdrawals when you reach retirement age, which could go up. Right now, I believe it's 65, but that could, they could raise that to 68 or 70.

By the time Eric is ready to retire, which will have. Implications on how much money you could possibly owe what the tax rate may be for you when you retire. So there are lots of other things to consider. I guess I would go the route of the Roth, and that's what I chose to do as well. The financial advisor that I work with at Wells Fargo.

That's what he recommended to me for both my 401k, as well as my individual accounts, just because of the nature of what I wanted to do. And as far as the choices that you have in the 401k, every company is going to be different. So Eric was mentioning that he didn't really have a lot of choices, and that can be typical.

I know that when I was at Wells Fargo, I believe we had about, I think it was about ten eTF slash index funds to choose from. We also had some international funds to choose from. We had a few bond funds to choose from, and then we had target-date funds to choose from. So we had a bit of, we had a bit of choice in our most of our match was paid in Wells Fargo stock.

So I got individual stock from that. Every company is going to be different, and you it's, you need to do your due diligence on that aspect of it. But like Andrew was saying, most of these funds are going to pay a dividend. So you're going to get the benefit of that dividend, even in the 401k. So if you're really itching to get the dividends, but maybe you don't want to pick individual stocks, then a 401k would be a great option for you as well.

But I wholeheartedly agree. And if you've heard me talk about any, anything. Over the last four years on the podcast. If you don't take that match, it's going to come through this microphone and strangle you. That's a

hundred percent return. That's free money. You got to do it. If it's 3% or it's 6%, like it was at Wells Fargo, you got to take advantage of that.

That's just, that's free money that you're not taking advantage of. And why are you listening to this show? If you're not going to take a hundred percent. Seriously, so yeah, absolutely. Please do that for yourselves because you will thank yourself in 20 or 30 years. Yeah, it's a great question, Eric.

Thank you for right then in, so Andrew, do you have anything else you'd like to take on.

[00:09:40] **Andrew:** So you're saying investors should not take their match and invest in Tesla stock or

[00:09:47] **Dave:** AMC, Robin hood. Yeah. All those names. Yep. Nope, Nope. Nope.

[00:09:55] **Andrew:** Got to come to the screen and strangle strangled we're now.

[00:09:58] **Dave:** I suppose it depends on when you bought the Tesla stock and when it is where it ended up, it was.

It was pretty ridiculous or turned there for a while, but it's been pretty, it's been down, I think, this year, but yeah, a hundred percent return. Yeah, you can't beat that. All right, let's move on to the next question.

All right. So I got a question from Nate. So he has a question. I had a question when it comes to valuing stocks or more or less afterward. So let's say you come for a company like Apple and bear in mind that this is just an example, but let's say you see there's upside potential for the price to be $170.

How do you determine when to stop adding to a position? What percentage is a rule of thumb? I know there's no hard and fast rule, but what's a good rule of thumb to follow, like 15 to 20% below an intrinsic value, more or less. Andrew, what are your thoughts on Nate's idea and his question?

[00:10:50] **Andrew:** I like to hear your first take.

[00:10:52] **Dave:** Oh, I knew you're going to do that to me. Okay. So I guess here's I have two ideas. So the first idea is a margin of safety is always a great way to go. Yeah. Especially when you're looking at a company that the future is maybe a little bit uncertain or you're not exactly sure what's going on with the company.

So Apple is a beast of its own. They are, I believe, the largest market cap in the world right now. They've obviously figured out a thing or two; I guess the biggest question with Apple. Is how much longer can the iPhone continue to dominate? And what is the potential growth rate of more people getting iPhones?

Now, obviously, the company has come out with other products. They have the watches, and they have the iPads, and they also have their Mac books and all the other great stuff that they're doing. But the question, I guess, is that I've always had in my head is how much longer can the iPhone continue to be the dominant device?

And I've heard people talk about this as one of the greatest inventions in mankind. I don't know if that I would argue with that, but I guess the question you want to ask about Apples, how much longer can I really continue? And it could, I don't have that answer, but that's a question that I would ask myself.

If I'm looking at investing in a company like Apple, you could argue that the price that you would pay for Apple right now is probably could be irrelevant because with the largest market cap in the world, one of the arguably best brands out there. One of the best-known companies. I think it has a pretty good reputation.

People don't seem to be as antagonistic as they are about other companies. Google people seem to get pretty, can get. Upset about the culture of the company and some of the things that they've done, not done Microsoft to a certain extent. Amazon can certainly be a trigger for some people, but Apple seems to be universally loved.

The app store thing has caused some angst among people that deal with it. But by and large, the company seems to have a pretty good reputation. So I guess the answer to that question is for me, I would want to buy something that has a margin of safety, but there's also this idea that Warren Buffett and Charlie Munger and a lot of other investors have talked a lot about is a company that earns great returns on their money.

So, in other words, every company earns income, hopefully. They have choices to do with; they have choices to make with the money that they earn. So they have the options of reinvesting back in a company, whether that's trying to produce new products or whether they're trying to grow revenues, whatever it may be.

It's called capital allocation; that's the term. And really, they can pay a dividend. They can pay down any debt they have. They can maybe buy back shares. There are lots of great ways that companies can choose to reinvest in themselves when they do those things; the idea is that they're trying to grow the company.

When you're looking at a company that has great returns on their capital, the more money than they make, the more that those capital returns grow; the idea is that the more the value of the company will grow over a long period of time. And a company like Apple, a company like Microsoft, a company like Google, Facebook, all these companies have these great returns on capital over long periods of time, which is one of the reasons why.

Continue to dominate, even when people start to think of them as old school, Microsoft Facebook leap to mind recently their valuations have come down to earth, so to speak over the last few years because people think they're boring companies. You could argue either way, but anyway, moving back to Apple is one of those companies that has had great returns on their capital or on their investments over a long period of time.

And they've proven to be a really good company. Warren Buffett would probably argue that the price you pay is a little less relevant than the return that the company can reinvent itself in over a long period of time. And if you do that, if you pay $170 a share for the company over 20 years, you're still going to get a great return on a company.

And that idea plays out in companies like Amazon, Costco just to that leap to mind. So generally. Suppose a company is really fantastic, like a company like Apple or Microsoft. I don't necessarily get as so excited about the margin of safety. I still want it if I can get it, like if something happens and all of a sudden the price of Microsoft drops, and I can all of a sudden buy it at a discount.

Yeah. I'm all in. But the flip side of that is you may not ever get that chance. And so I guess you have to balance that idea, and I'd be willing to step out on a limb and buy a company like that with a lesser margin of safety. The flip side of that is if I'm looking at a company that is not as wonderful as somebody like Apple, then I'm going to insist on a bigger margin of safety because I don't feel like that maybe that investment is as good as something like Apple and you always have to weigh the opportunity cost of buying a cheap company that may go up for a little.

And you get a nice return over a few years or paying a little bit more for a company that gives you a great return over 10 or 20 years. So you have to balance that out, and it really comes down to what you're comfortable with and how much risk you're willing to take, and how much you think you can handle any sort of fluctuations that will happen in the market and with the company.

So I guess that's kinda my idea. I'm now curious to hear what Andrew has to say.

[00:17:03] **Andrew:** Trying to think of like rules of thumb, and there's so much danger in that, but here's what I'll say. I agree with Dave in the sense that, if we're the, make it really simple because how you perceive the value of a company can get crazy complex, but just to be simple as using something like the price to earnings ratio, PE ratio.

If I had two companies and like Dave's example, one company seems to be a much better company than a second company. Then I would want to pay a lower PE ratio for the company. That's maybe not as good versus the company that has really great prospects. And so to Dave's point. The less attractive business, probably you want to have a higher margin of safety.

And so that's why we can't put a certain number to say you should buy every company with a margin of safety of 10%, or you should buy every company with a margin of safety of 25%. Because if you're looking to buy companies for the long-term. That's not a really realistic goal. If you're doing one of these kinds of value strategies where you're buying super dirt cheap, you're diving into the deep end, and you're going for the car.

You're trying to find cigar butts, and you're picking those up. As soon as they rise up to fair value, then you're selling them and getting rid of them. And you're just constantly turning that bow over and over again. Then that's an approach where it's going to be very. More conducive to like setting strict rules to say I'm the only buy when it's 50%, maybe when it drops down to 25% margin of safety I'm out.

And then you just do that same process over and over again. That's certainly one way to go. I think when you look at something, that's a little more long-term and a little more buy and hold and a lot more Buffett. And even when you talk about Buffett, he used to be like that churner in the beginning.

And then as he maturity became more buy and hold, then that's where you have to factor in, how long do I want to hold this business? How certain am I of the business able to do well over a long period of time? Some businesses. To me, when I look. In a lot of technology businesses, I get really skeptical.

Or if I look at even a lot of the growth companies, and then if you mix growth companies and technology businesses, I get super, super sick skeptical because it's These companies haven't even decided who the leader is yet. And then you already want to say, you're going to hold it for ten years, but you don't even know if they're the leader yet.

There are so many other businesses, other already the leader in what they do. It's already established why people like them, and people already have their buying habits with them. And so that's a much easier investment for me to make, but it all comes down to Choosing between; what are my opportunities today?

Because every day it's going to be a little bit different. So you got to fish where the fish are, take where your opportunities are, wherever they are, and then weigh the alternatives and maybe try to think, can I bring some humility to it too? So if we think about somebody like Warren Buffett, even when he looked at buying American express.

So this was like his first grand slam investment, one of his first, because they had a big scandal, American extra for us dropped what? 20 50%. I think they dropped. Yeah. And Buffett knew like this was as much of a slam dunk as you could get, but he still had the humility to say, I'm not going to put all my money into this.

I'm going to—40%, which is a huge percentage, by the way. But I'm going to put 40% of my money into American express because I'm going to leave a small chance that I'm wrong. So he had the humility to look at his portfolio in that way. And so, when we look at what we think a company's intrinsic value is, I think we need to bring humility into that and the fact that maybe we'd be wrong.

And so not only do you have to think about what's the right margin of safety for me, you have to think about. Am I leaving a margin of safety in that I have enough diversification in my portfolio, so that if I'm wrong about what I think Apple's worth, or if I'm wrong about what I think Facebook is worth, whatever those companies are, as long as you spread out your bets enough.

And even I liked the idea of spraying it out over time. Maybe you really like Apple. I would prefer to see an investor, maybe buy one, one year, buy some more a year after, by sophomore year, after that, some of the best investments they don't just go to the moon, and you missed out.

They just continue to do what they do for long periods of time. So I think the more you learn, the more. The more you get comfortable at the businesses, the more skills you get analyzing, what you're comfortable margin of safety is. And the more humility you have, I think the better off your results will be.

And for a rule of thumb, maybe that's less of a rule of thumb and more like a rule of many hands, but hopefully, that gives you some insight into what kinds of things to think about when you're trying to determine the margin of safety.

[00:22:05] **Dave:** Yeah. Those are all; we're all great insights. And I think the idea of having rules of thumb are a great way to give you a framework, but then, as you gain more experience and as you start to learn more about how the different businesses work and how the different industries work and accounting and valuation, and a lot of these things, you'll start to appreciate that every company is.

When you start analyzing a company every time you step into that arena, it's like you're learning something new all over again. And it may be that you are embracing an idea about a certain company, I'll just pick one, let's say Walmart, and you're learning about how Walmart does their business and how they operate and the financials and their culture and all these different aspects that you take into account.

You may think you may decide that, Hey, yeah, I really like where this company is going, and I really like this, but then you start learning about some of their competitors. You start learning about Amazon, and you start learning about Target and anybody else that may compete with Walmart. And you start learning about how those companies operate, and maybe you like a little bit of what target does versus the other two.

And maybe a little bit of what I'm, as on does compare to the other two. And just because you decide that you really like Walmart doesn't mean that you can't like other things about those other companies. And it also doesn't mean that you can't go maybe down the road because you weren't about one company that you pick up investment in another company, because sometimes they offer different options and they also offer different opportunities.

But I think the idea of you have to buy a low and you have to sell high; obviously that's the ideal thing you want to do. The other thing to keep in mind is I'm going to use Costco as an example. Costco is selling for around 400 and some bucks a share. I don't have the exact number here in front of me, but let's say that you,

two years ago, really fell in love with this company, and you passed on it because you just felt like it was too expensive.

And then a year later, you decided to take advantage of what you thought happened in March, and you got in for $280 a share, and now it's up to 400 and some bucks a share. You made a great return over that period of time because you took advantage of an opportunity that may have presented itself at a particular point in time.

And you still were able to get in on a great company. It may still have been expensive at that time. The idea that Warren Buffett. Jumped on American express is a great example of the kind of what we're talking about. He took advantage of a situation that presented itself that caused the price to drop off a fantastic company.

And if you looked at the financials from one year to the next, when that oil scandal-hit American express, Everything looked fantastic. There was zero chance, but people freaked out because they thought that American express was going to go bankrupt. And if you looked at the whole situation as an overall idea, the backup for just a second.

So, in brief, one of the subsidiaries that American express owned had a scandal within there. With salad oil, and I'm not going to go into the whole details. But the basic idea, yeah. Is that if this subsidiary declared bankruptcy, that would cause American express to go bankrupt as an overall company.

But as Warren Buffett quickly determined by looking at the financials, the value of that total value of that subsidiary was less than all the cash that American express had on their balance. In total and not to mention the ability to borrow money, to sell shares. They had lots of resources to be able to cover that liability.

If it came to pass would have hurt the course, it would hurt, but it would not bankrupt the company. And that's what people were expecting, was that American express was going to go bankrupt. And at the time there was a fantastic company, sales were going up, everything was going great. So he saw an opportunity to jump in on a company that frankly, in, in that time, Was expensive.

Now, if we look at it today and we go, oh my God, that's so cheap, but the times were different. And so the ability for him to take advantage of that is, is a fantastic idea. But I think the whole point of what Andrew and I are talking about is you have to take a company by company. You can have guidelines and things you look for in every company.

And that's what you should stick to. But as far as having hard and fast rules about I'm going to only buy things that are 20%. Their intrinsic value that'll work, but you're going to have to wait a long time to find certain companies. And you're going to have to be comfortable with not buying anything for a while because some of these companies, they really you might have to wait a while for them to come down.

So you have to, again, you have to balance the opportunity, the cost of whether I want to take advantage of it now, or if I just want to wait and see if it ever comes into inter the zone that I want. There, there are lots of options to think about all that.

[00:27:22] **Andrew:** Maybe as a rule of thumb, just to start, maybe you say, pick a number 15, 20, whatever it is, but then I'm going to allow myself to break that role once every three months, once every two months, once every four or five months, whatever it is. And I think that would be a good place to start. Then you can take it from there and evolve it.

[00:27:42] **Dave:** Yep, exactly. And the other idea about this too is that you don't have to. You have the choice of how much of a company you want to buy. So it's called position sizing.

And so let's say that you really like Apple and you'll want to take a flyer on it, and you want to buy a little bit of it. So instead of putting a thousand dollars into the company, maybe only put $500 into the company, and you use the other money to buy something else that maybe has a bigger margin of safety.

That way, if Apple doesn't pan out as you want, you're not out that much. But you still took the chance, and you still have the other investment that could help balance out. Maybe Apple is not performing like you'd like it to, so it's a great way to start to get your feet wet. A lot of big investment firms will do that; they'll find it a target, a company that they really want to learn more about. And they'll take a starter position. They'll buy a very small amount to get skin in the game, so to speak, and then they'll start learning more and more about the company. And then they'll start.

They'll start to up the position size of the company. And it really comes down to what you're comfortable with, but those are some additional ideas that can help you take advantage of it. And the other thing too is there's nothing wrong with taking a flyer on something; it's, I think it's better to scratch the itch and buy a company like Apple than to completely ignore it and then lose interest in its thing and then completely drop out of it and not do it at all. It would be better to have bought one share of the company and then go on to other things than to just not invest at all.

[00:29:20] **Andrew:** Maybe there were a lot of investors who do that with Gamestop.

[00:29:23] **Dave:** Yeah. Yeah. That's a good point. So I think it's a great question, and I think it's a good idea to have different rules of thumb and different guidelines and principles that Andrew and I have talked a lot about throughout the history of the show. But I think it's also good to be flexible and have an open mind about different companies and the idea of being humble about some of these ideas.

We don't know everything, and not every investor does, and not every investor guru is going to either there are no perfect people. And as much as we both look up to Warren Buffett, he's made mistakes. He's made poor choices and poor investments that have not done well for him or for the company.

And it's just the nature of the beast, but the idea and the thing that's made him so resilient and so outstanding is he's worth trying. And he's hoping, as he puts it, tried to learn from those mistakes and not repeat them again. But he even says in his letters that he's made mistakes, and he's bound to repeat them.

And he's human too. So keep that in mind,

[00:30:26] **Andrew:** What gets me inspired is how you don't have to know everything to make a lot of money with the market. You can just have that circle of competence and just be good at what you know, and then it can do a lot of things for you.

[00:30:41] **Dave:** Oh yeah, absolutely. Yep. Absolutely. You could be a generalist, or you can be specific and weren't everything there is to know about airlines, for example, and you could be the expert on airlines, and you can do fantastic. You are buying companies that are airlines and related to that specific field. It could be anything; it could be pharmaceuticals, it could be the auto industry, it could be FinTech, whatever.

Yeah, there are lots of opportunities out there.

[00:31:03] **Andrew:** That's going to do it for us tonight. I guess we'll answer that third question than the other night. Yeah, these are great ones.

Appreciate you guys writing them in; keep them common as you always do. We really enjoyed answering them and hopefully enjoyed listening to them just as much. We did have an idea, so I don't know if we've done an episode strictly on—stock market jargon. And to me, I've gotten to the point where it's really hard for me to know what's jargon anymore and what's like regular English.

So if you want to reach out to us on Twitter, we're at Twitter IFB underscore podcast,

[00:31:40] **Dave:** IFB underscore podcast. Yes.

[00:31:42] **Andrew:** Okay. Go to the I F B underscore podcast and let us know what jargon you want us to explain on the show, and we will feature all of those on an episode. So go ahead and do that. And I'll look forward to hearing.

Yep. That would be awesome. We would love to help you guys work on some of the jargon and some of the languages we've talked about before; investing is definitely a language, and this could definitely help you. So we're going to go ahead and wrap it up for tonight. We appreciate you guys taking the time to write us these fantastic questions.

Again, keep them coming. And without any further ado, I'm going to go ahead and sign this 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.