# IFB213: Intrinsic Value for Beginners

*[This transcript was generated by artificial intelligence. Timestamps are not 100% accurate depending on the platform used for listening].*

I love this podcast because it crushes your dreams and getting rich quick. They actually got me into reading stats for anything you're tuned in to the Investing for Beginners podcast led by Andrew Sather and Dave Ahern with a step-by-step premium investing guide for beginners. Your path to financial freedom starts now.

(DAVE) Alright, folks, welcome to Investing for Beginner's podcast. Tonight, we have episode 213, and we're going to go back to answering some great listener questions. We got a fantastic one from Kevin, from New Zealand, which we will answer tonight. So we're going to spend a little bit of time talking through and working through this question cause he's got some really good, interesting nuggets in here.

So Andrew and I thought this might be a very interesting discussion for everyone. So I will go ahead and start reading the question. So I have; I started investing in November last year, a New Zealand stocks and moved to US shares about March this year. Intrinsic value. I hear you guys talk about it all the time.

And I've looked at a few ways to calculate and read the current nuggets series avidly. I want to add a calculation to my sheets that identify what I think the value of a company or share is to understand if I'm paying dollar for dollar. Is there a good go-to formula that I could use for this?

And that would work in New Zealand, given the additional reporting and financial system. Be great to get any advice on this as I am comfortable with buying into businesses, but struggling, when to jump out of ones that I bought before following the VTI system; I have some shares that are doing well and some not so much.

I plan to put all of them through the VTI once I understand which numbers are the most. I think I may be holding on a bit too tightly to Warren Buffett's number one rule, and I'm holding when perhaps I should be moving on and accepting the bad decisions I may have made earlier while most likely speculating many, many thanks and keep up the great work regards Kevin.

So Andrew, let's go ahead and. Start taking this question apart. So what are your thoughts on the first part of Kevin's question here?

(ANDREW) So basically intrinsic value, and he was talking about your nuggets series, which by the way, that's a weekly email that you send out super cool. You put many helpful links to different things, investing and personal finance.

So people can subscribe to the email list for the free stockmarketpdf.com, and you can get access to that and the intrinsic value. So everything about this question, talking about how you buy stocks and then how do you sell the ones you've made mistakes on? And intrinsic value is tough because beauty is in the eye of the beholder.

And while that can be kind of opaque and maybe discouraging at the same time. I think understanding how companies are valued is a process. And I think starting with the basics is a great place to start. And, if you think about the basics of a company, They bring in sales, have costs, and have profits.

And so we want companies that can grow those profits over time because that's how their stocks become worth more. So that's kind of where I would start. You'd start with the basics. And if you don't know anything about the stock market, you start there, and then you figure out, okay, well, how can I learn about a company's profits?

Well, there's this thing called the price to earnings ratio and what that tells you. I mean, you're not going to be able to buy a company dollar for dollar. I know he mentioned the dollar-for-dollar concept. You can't buy a company for a dollar and expect $1 in profit. There's always going to be a premium there.

And one of the ratios that helps you, the measure that's called the price to earnings ratio, and it tries to tell you. For however many dollars you're putting in, how many earnings is the company earning for you? And so that's taken from the stock price in the market and compared it to the company's earnings.

So that would be, I guess, the first step. And I think that's hopefully an easier concept, and it gives people enough to chew on; I guess if some of them understood the price to earnings ratio and wanted to get more advanced. You know, that's, that's a tough one, but how would you unpack, going to maybe step number two from that

(DAVE) Oh, boy has, that's where it starts to get a little more, it can become more complicated, and you have to think about it in a variety of ways.

So I think the first thing that you have to understand is when you are valuing a company, You are trying to assign a value that you think it's worth. And the comment that Andrew made about beauty is in the eye of the beholder. That is really that's really what it comes down to valuation or valuing a company is an art.

It's also a science and. There's the number, part of it, which makes it a science, and there are formulas and all kinds of different ratios and things like that, that you can take this number and plug that number in and all those kinds of things. And you can argue to the cows, come home about what kinds of ratios you should or shouldn't use.

What's the right thing to use, what's not the right thing to use. There are lots of varying degrees of who's. Right. And who is? It all comes back to what you think the value of that particular company is, just like you think of the value of the houses. The car is, the guitar, the steak, the milk, whatever it is, we all have a particular value.

And when we're talking about what we think things are worth, there's lots of conversation here in the United States about inflation, and there's lots of conversation about the price of gas or the price of milk. It's all relative to what we think it should be worth. And when it's more than that, then we feel like it's expensive.

The same kind of idea applies when you buy a stock in the stock market. And it doesn't matter whether it's Apple or PayPal or Tesla or Door Dash or Airbnb or Berkshire Hathaway; all comes down to what you think the company is worth and what you consider a fair price. To buy it for how do you figure that out?

Well, there's no simple, easy way to do it. And if there was an Andrew and I'd be out of a job because then everybody in a brother could do it. So the multiple that Andrew was talking about, the price to earnings ratio is probably the most common, I guess, easiest metric to use the only trouble with using a metric, like a price to earnings is relative.

And what that means is that you are comparing. One ratio to another, and in some cases, you could be comparing it to itself. In other words, I could look at the price-to-earnings ratio of Berkshire Hathaway or Apple, and I can compare it to Apple. And so I could say that one year the price-earnings ratio is 20, for example, and the other year it's 18.

So now I'm saying that this year is more expensive, but that's only in relation. To last year, there's one kind of, I guess, a hurdle to overcome. The other hurdle to overcome is you have to compare them. You can also take that PE ratio and compare it to other companies in the stock market. So if you take Apple and you look at the PE of Apple and let's say again, it's 20, and you compare that to a company like Microsoft or even Amazon.

So Microsoft has a PE of, let's say, 30. But Amazon has a PE of 45. Well, now you're saying to yourself that Apple's cheaper than the other two companies because their PE is lower than the other two. Okay. Fine. That may be the case, but where it gets tricky is when you compare them to other markets, maybe outside of what Apple operates in, or if you compare it to other types of companies that may have different types of businesses.

And I'll give you a couple of examples here. So let's say that you compare Apple to Wells Fargo. So Apple is a computer company. Their business operations are much lighter in that they're a far more profitable company because of the nature of how they operate and what they say. Wells Fargo is a very capital-intensive business with lots of money, and their margins are much, much lower.

And it's just far less profitable than a company like Apple is, so a PE for a bank like Wells Fargo could very well be 8, 10, 12. And so now you're with. You and Wells Fargo and comparing it to Apple go, wow, that's cheaper. And if you compare it to Microsoft and Amazon are earlier examples, it's even cheaper than them.

You're like, wow, what a deal? It's a steal. It's awesome. But not so fast. So now you're looking at. A company like Wells Fargo, and you're deciding that it's cheaper. Well, yeah, it is. It's cheaper on a relative basis than the other companies that you compare to too. But now, to really get a sense of whether Wells Fargo is cheaper or not, you have to compare it to other banks because you have to keep it within the same.

Sector to make sure that it's a relative comparison, that it's, it's an Apple to Apple comparison because if you compare Wells Fargo to Amazon, you're really comparing an Apple to a Kiwi was just they're light-years apart. They're nothing alike. And so it's not a fair comparison. It'd be like buying a car.

Suppose you go to buy a Hyundai. And you compare the price of a Hyundai to a BMW. Well, they're not going to be the same. They're not going to be in a light-year of the same. So is it the same idea that works with stocks? And so you have to think about just beyond just a simple PE ratio, you have to think about beyond what am I comparing it to?

Because again, it's a relative. It's relative to itself. It's relative to other companies you compare it to, and if you compare it to companies outside of its sector or its industry, you're not going to get a fair comparison. You could make a mistake, and you could buy something that actually is really kind of expensive.

And again, when we're talking about expensive, we're not talking about the actual price. So if you look at a company, company A that's being $50 a share. And you look at company B, that's also $50 a share. Dollar-wise they're exactly the same, but the value of those companies could be light-years apart. The PE ratio for a company, A could be, I don't know, 15 and the one.

Company B could be 125. So the one that's got a P 125 is super expensive because, in essence, what you're doing is you're paying 125 times more for that dollar of earnings than you are for that dollar of earnings for a company A, which only has a PE of 15. So hopefully, that makes sense to kind of go back real quickly.

A PE ratio is a relationship between the price. That the company is selling for in the market versus the profits or the earnings that the company earned for that particular period of time that you're measuring, whether it's a year or whether it's a quarter. And so it's just a simple ratio of the price of versus compared to the earnings and generally the lower, the number, the air quotes, cheaper the company is.

So hopefully, that's, I guess, a good starting point; where should we go from here? Do we want to delve into some of the more complicated parts of this?

(ANDREW) Noo, And then I'll just give one additional component. And I think it really encapsulates whether you're doing a full DCF, like a super complex spreadsheet, or you're trying to keep it super simple.

And Peter Lynch, somebody who popularized the. Unfortunately, I wish this was popular as more Peter Lynch, one of those great guys, just like really bridged the gap for investors who might be normal everyday people and really make it approachable and give them enough to move along and start to learn about the stock market.

So if you haven't read any of his books, beating the streets, Fantastic. And one up on wall street is also great, and he has one of the best mutual fund managers we've ever seen. So for his time period, he always talked about the peg. So you're taking the PE ratio, and you're just adding an element of growth there.

So they go back to your example with Wells Fargo and. If Wells Fargo is the Hyundai and Apples of BMW or guests at the BMW go a lot faster. And so, you know, profits are good when it comes to businesses. But what you want is you want those profits to grow over time. And so what you'll tend to see in the stock market is the companies that can grow the fastest.

Those tend to have the highest price-to-earnings multiples. And so that's where Peter Lynch uses the PEG, and it makes it really simple. It just adds growth into the equation. And then you get a simple number, and you can use the PEG now to compare the PE and the. And compare company by company.

And that can help, I think, do something more broadly across other industries where you can start to get more of apples to apple comparison because you are taking that into account. I mean, you look at something mature, like banking. It's probably not going to grow 15% a year, particularly one of the big mature banks; they are big.

And so they need a lot of extra profits in order to get bigger. They're getting a lot of deposits and all of that now, but it's; still, they need big amounts to grow. And just at that size, it just, you have slower growth. And

so that you'll see lower PE ratios for there. Some of them like Apple. I mean, is there anything like the iPhone and the whole iPhone ecosystem

(DAVE) Noo

(ANDREW) And just the fact that people, people will put their phone payments as like one of their bills.

Now it's like, I've got to pay rent. I gotta pay insurance. Oh yeah. And I gotta pay for my Apple phone. They're very efficient with the capital, and they're able to make that grow. And so. Investors recognize that I think the science of it when you talk about the art and the science of intrinsic value, the science of it, I think comes down to the earnings.

And then, if you want to get to the next level, you look at free cash flow. That's what we do. But the art of it is really interpreting that growth. And that's where the eyes and the beauty of the beholder are because I could think that Apple's great, but somebody next to me could think that it sucks. And so maybe they think that Apple is only going to grow 5%.

A year is moving forward; maybe I think it's 7%. And so that difference between where we think that the companies will grow moving forward and how we interpret what a company has done, where they're at, and what they're likely to do. That's what changes, what I think is a fair price from what you think is a fair price.

(DAVE) Yeah, that's a great example. And I a hundred percent agree with that. And I wish that Peter Lynch was talked about a little bit more because he is definitely he's right up there with Warren buffet as being one of the better teachers out there of taking complicated subjects. And breaking them down into pieces that people could understand without having a degree in finance.

He weighs things out that way. People can really easily understand it. There's a lot of great phrases that are really related, and he puts things in a way that just makes them more approachable and accessible. And I guess to kind of continue a little bit of what Andrew was talking about with the growth part of it.

(ANDREW) Yes, sir. I think. Get off the rabbit hole and move on. Do you mind if I like butt in here?

(DAVE) Not at all.

(ANDREW) So speaking of really great phrases, this actually goes to Kevin's second part of his question. He talked about Warren Buffett's rule number one. So what was that role?

(DAVE) Don't lose money.

(ANDREW) Don't lose money rule number one, don't lose money rule number two. Don't forget rule number one. So. And the application of how he's talking about it. He's looking across his portfolio. And I think this is natural. As you grow as an investor and you start to learn more about the stock market. You can start to look at your portfolio, and that can start to look real ugly, depending on how long you've done it and how much you've learned, and how quickly that's happened.

So what are your thoughts on Kevin's second part of this question where he talks about. On the one hand, he does not want to lose money on what he's picked; on the other hand, feeling like maybe he didn't make the best decisions on some of the stocks he has.

(DAVE) Yeah. That's, you know, trying to decide when you want to get out. And when's the right time to sell is arguably ten times harder than when it is to buy because so many of our behavioral biases kick in ideas. Like, I don't want to sell out because it could get worse. At some point, if I just hold onto it long enough, there's also the idea that we feel a loss, what two or three times more than we feel when so emotionally it's more taxing on us to feel a loss than it is to feel a win.

And those are just a few of the behavioral biases that we deal with when we're trying to make a decision about whether we want to, to cut bait and. Cut our losses, whatever phrase you want to assign to that; it's easy. I think the hardest thing, one of the hardest things to do when you're investing. So how do you go about doing it?

I think there are several things that have to be; I guess these are some of the things that I guess I think about. So when I think about what's going on with the company, if I see something in the company that I think is fundamentally changed about the business, then I'm out. In other words, if it's a company that has, has always sold tires and now all of a sudden they decided they want to be in spaghetti.

I'm out. We're done here. It is not going to happen. When you see something that has fundamentally changed about the business, whatever it may be, then it's time to change. It's time to get out. Other things that could happen would be, let's say, that there's been a management change and the person that. Taken over is weeding it in a direction that you don't believe is going to be in the best interest of the business, as well as you as a shareholder on out then, because the management, the people that drive the bus, they're the, really, the ones that set the tone for what's going to happen with the company now and into the future.

And if they're setting about a bad foundation now, then it's going to make it even doubly harder to overcome in the future. Ideally, when we buy a company, as Peter Lynch has said, ideally, when we've bought a company, we want to buy a company that any monkey or any idiot can operate because eventually, one will want ideally when you pick it, you want that.

But hindsight is always 20, right? So on the back end, if we've bought a company and maybe it's not doing well, and management is not in a great position, or they're just not leading it. Well, then you have other decisions to make. But the other side of things, and the other decision you have to make is you have to look at kind of the overall sector that the business is operating in and decide whether you think that this is something that can continue to grow and be a profitable enterprise.

And you think about something like. Well, a good example is what happened to Nokia phones and Kodak. They're in an industry that changed fairly quickly. And if you weren't invested in those companies and you didn't see the writing on a wall, then you would have been left holding the bag. And so sometimes you have to pay attention to what's going on with your investments.

And if you're buying car companies that are not trying to. Move towards any sort of electric vehicle at all and their inventory in now or in the future; you got to ask yourself, is this really going to be along with good long-term investment? Because whether you agree with that on a political side of things, it's coming and.

If you don't change with that, then you could be in a big hurt. So you have to think about what's happening with the business. And you have to think about some of those other things that I was talking about. So those are just kind of starting points. What are you, what are your, some of your thoughts?

(ANDREW) You know, I think that covers most of it, and you can get so complicated with when to sell.

And if you're really looking for an approach where this is what I try to do, I try to do my best to find the. Businesses that I can buy at a good price and then let the businesses do the rest. So you can totally take an active approach, you know, be trained in and out, trying to pick up pennies in front of a steamroller, a lot of value base people will do that.

And I used to do that decided I liked the longer-term approach now, the more hands-off approach. And so if you're doing that, hands-off, I'm going to buy, I'm going to let things compound and let those businesses do the work for me. You really want to minimize how much you sell and not don't be spending all this time micromanaging your portfolio.

I mean, I came to the realization. Uh, where you spend more time figuring out when you're going to sell, that gives you no time to figure out what's the next opportunity. That can be a huge thing. And that's why I think the idea that you've described Dave, this such a simple question, you know, has anything within the business fundamentally changed and.

The first time you said that, I think it might've been on the show, but it really stuck. And, uh, one of our listeners Gillware, he mentioned, I think it was on Facebook or Twitter, uh, you know, repeating that. And that's a great reminder, and it's something that I try to remind myself of all the time. And even when we're preparing, preparing the, to answer this question, and it slipped my mind, so I'm glad you brought it up, and it really just comes down to that.

I think one way that can kind of give you an indication a lot of times If something has fundamentally changed with the businesses if they've always been profitable and all of a sudden they're not. For me, that's one of my cell rules. And so if the, if they go negative earnings, then I'm selling on that.

And that can be a good rule of thumb to keep in mind. I guess the last part of the, um, the question about, you know, what do I do with all these ugly ducklings in my portfolio, I would say this whole process of managing a portfolio, being a stock market and investor, it's a long process. And so. You know, just because you feel like you're a hundred times smarter than you were yesterday, you're probably not.

And you know, some of the companies may actually be guys then, and you might have overlooked some of the good aspects of it. So go to Buffet again cause he said something about you want to evolve and improve the way you do things, but he says, do it over time. Don't do it all at once. And so. Try to think they're in and do a deeper analysis and maybe slowly transform your portfolio rather than just chopping it all and starting over.

I mean, for all, you know, there could be great parts about these businesses that you're completely missing, that you'll find out two months later and you you'll be like, I wish I didn't let go so soon because I didn't think of this.

(DAVE) Yep. I agree with; I keep coming back to this idea of what we have to; when we have to make changes with our portfolio, we have to think about kind of digging up the weeds, and you don't have to go through your whole garden and dig them all up all at once.

And. I think a great practice to do. Let's say that you have four or five companies that you're like, kind of on the fence about is when you decide to cut bait with one of them, or two of them is find someplace that you can take some notes and write down why you're making this decision, because. As you, as part of your learning is to think about the companies that you let go of is just as important as the ones you decide to buy.

Because a lot of times, the decisions that we do to make a decision to let a company go can be something that you can look for in a new company that you're investing in and or analyzing. And a lot of times there are companies that you will buy that you will think are the greatest thing ever. And then, over a period of time, maybe your views will change.

And it's not necessarily that the stock will go down, but maybe it just kind of trades sideways for a while. It just doesn't. Anywhere. And I'm actually dealing with that myself. I have a company that I bought a while ago, Intel, and I bought it almost two years ago. And it's really, frankly gone almost nowhere in two years.

Meanwhile, the S and P 500 is like, you know, up a hundred thousand percent since then. Not that much, but it seems like it. But one of the things that I've been struggling with is that I look at my idea of why I thought the company would do well, and it's not playing out. And if I look at the financials of the company, it's really strong.

But sometimes, what you think is a great idea or a great investment, the market may not recognize, or it may take a long time for it to recognize. And so, just because we come up with what we think is a great idea, it doesn't always mean it's going to go that way. And so that's what I'm struggling with right now is do I, do I continue to hang onto Intel, or do I just, you know, realize that.

You know, my thesis was wrong, and I made a mistake and cut bait, and I haven't come to a conclusion on that. I'll probably let everybody know when I do, but those are all things that definitely go through my mind when I'm thinking about, you know, a company like that. And it's hard. It's really hard, but I think a great practice is to write down some of those ideas that you have of why you sell the company.

And when you look at those, when you go to buy new companies and see if any of these new companies fall into any of those. Those patterns or those categories because could help you avoid getting into a company that, somewhere down the road, you may have to turn around and get.

(ANDREW) Yeah, that's great.

(DAVE) That's okay. All right. So we're going to, with that, we're going to go ahead and kind of wrap up one of the thank Kevin for taking the time to send us that great question.

We really enjoy talking about this, and hopefully, we will help to answer some of Kevin's questions. I know there's something else we kind of wanted to take on about that.

(ANDREW) Yeah, we do have this thing called the little package evaluation. We haven't talked about that on our podcasts. It's definitely very, very advanced.

So that's kind of why we don't talk about it, but you can go on our website and check that out. I use one of them; I actually use both of the DCF spreadsheets in there when I'm estimating the intrinsic value for companies. So, you know, for people who do get. Across that bridge and want to really use the kinds of tools that we use.

That would be the place. And then obviously the value trap indicator too. I use that on every stock as well, but that's more. Yeah. That's a whole nother conversation for another day.

(DAVE) Yeah, exactly. But those are great tools that, that could help you with some of the intrinsic value ideas that we were talking about as well.

So you can check those out at the website. We also have our Twitter feed, which I've been running now for a few months, and we've gotten a lot of great followers on there. So thank you. Every everybody that's following us, that's really humbling that you guys consider us valuable enough. Give us some of your time.

And on Fridays, I try to put out little Twitter threads about different companies. I've talked about Google; I've talked about Visa. I talked about Topicus last week, which is a Canadian company that will actually help another one's company. And then this week is going to be Palantir. Oh, there's, you know, all kinds of interesting stuff.

And you can reach out to us and ask us any questions on there as well. So I guess without any further ado, we'll go ahead and sign off. Thank you again for sending us great questions. 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.