IFB217: Investing in Carbon Credits and Useful Metrics for Beginners

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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 beginners Podcast. Today we have episode 217. And we're going to go back and answer some great listener questions we got recently. So without any further ado, go ahead and read the first question.

So I have Andrew and Dave, I recently opened up a Roth IRA through fidelity. Is the investing strategy, any different with a Roth than it is with buying stocks with an individual brokerage account? Appreciate your thoughts, PS. Dave, I'm a big baseball fan and X player myself, so keep crushing the baseball analogies?

Absolutely, we'll do. Thank you for the softball pitch. And we're going to attempt to hit this baby out of the park. So yeah, so Andrew, what are your thoughts on a great question about the Roth IRA?

ANDREW All offseason fun, the strategy part? So like the logistics wise? The short answer is there's not much difference, maybe more of the long answer, there's a little bit of taxes, but you get if you're using a reputable us broker, one of the big names Fidelity, Schwab, Merrill, anybody like that, they will send you the forms automatically. And you can just for those to your tax accounting, put on TurboTax, whatever. So in that regard, the logistics of Roth versus a regular brokerage account, are not all that different. Like I said, the taxes are different. And so there are some people who will look at the differences in taxes and kind of use that to their investing strategy.

And I think that can be smart in certain situations, and it really depends on yourself. So one idea of that could be if you have stocks that you're buying that do not pay a dividend, then you put those in your regular brokerage account. And if you have stocks that do pay a dividend, you put them in your Roth. The reason for that is the dividend tax, you don't have to pay taxes on your Roth. So any taxes from dividends, you won't have to pay on those stocks that pay a dividend. So that's one idea.

But if you buy a stock in your individual account, and let's say it's like, the next Amazon and at 10 taxes, well, whenever you sell, eventually, you're gonna have to pay huge taxes on those capital gains. Whereas if it was in a Roth, your 10x, your 10 bagger, another baseball term. Yeah, well not be taxed on the capital gains.

So kind of two things to keep in mind there. I mean, for me, personally, I more look at like, what is this stock going to do for me, but I don't change the strategy necessarily based on individual or Roth too much.

DAVE So would you buy a stock? Doesn't matter what kind of stock you can literally buy? You can buy Google for each type of account, correct?

ANDREW Yeah.

DAVE Okay. So I think I was wondering if that was part of the question is you can do you have to buy different kinds of companies to invest in the different brokerage accounts, and you don't,

ANDREW Yeah you really don't?

DAVE Yeah, that makes it a lot easier. And like Andrew said, The any reputable brokerage account will take care of the tax part of it for you. And like he said, at the end of the year, they'll send you the information and you can forward it to QuickBooks, or anybody TurboTax anybody that you use to do your taxes, it makes it so much easier. Back in the old days, you didn't have that advantage. But now you definitely do.

And like Andrew said, there are different kinds of tax strategies that you can enact to help reduce the impact of taxes over time. But if those are things that you're interested in, I would strongly encourage you to talk to a tax professional to get some guidance on what's going to work best for you. Because everybody's situation is a little bit different. And depending also on your age, and where you kind of are in your retirement plan that could have an impact as well on what kinds of taxes you're trying to avoid, and how you're trying to avoid them. And for those of you who are a little bit unfamiliar with what we're talking about a Roth IRA is a type of brokerage account or retirement account, that basically says you don't have to pay the taxes, you pay the taxes.

Now, you don't have to pay the taxes later. Whereas a traditional IRA is you don't pay the taxes now, but you pay the taxes later. And a couple of the benefits of those types of accounts, a traditional will reduce your tax code now. So just easy numbers, let's say the you invest $5,000 In your traditional IRA for the tax year, that means when you go to pay your taxes, you will pay, you will only have to report $45,000 in income as opposed to the 50,000 because you've had the traditional and that reduces your taxable income for that particular year. However, at the end of the term, I believe it's when you start to turn 6870 A blanket on the exact numbers, but you have to start taking required distributions at that point.

And when you do that, then they will tax you on any money that you have in the account. So there is it's kind of a quid pro quo, the government scratches your back early at the end, you scratch their back and with a Roth IRA, it works kind of the opposite. So if you make 50k and you invest $5,000, there's no tax. There's no upfront tax benefit at that time.

You pay the taxes on the 50,000 that you earn for the year. And the money that you put in the account is tax free. So in other words, at the end of the time that you want to start withdrawing that money to go live on the beach and enjoy your pina coladas, then at that time, you won't pay any taxes on the money that's in the account. So that's in essence, how both of those accounts work. And when you work with brokerage accounts, whether you work with brokerage accounts, or savings accounts or CDs, the rules, they're all the same. And it all applies. And it helps make it a little bit easier when you're trying to set up the accounts.

But again, depending on what your income is, and also depending on what your tax situation is, and where you are, in your retirement plan is a good idea to talk to a tax professional, and get some a little bit of guidance on maybe some ways that you can help minimize some of those effects of taxes, especially if you

have a traditional IRA. The same rules apply, by the way, if you have a 401k. So you have the ability to do a Roth or traditional IRA with your 401k as well. So those are all things to keep in mind when you're trying to work on all that stuff. Okay, Andrew, did you have any other thoughts? He wanted to talk about the great question about the Roth IRA?

ANDREW No, I think that's your He covered it really well.

DAVE Okay. All right. Let's go ahead and move on to the next question we have. So hey, Andrew, new listener of the podcast. I've really learned a lot in the past two weeks after kind of skipping around a bit and listening to the episodes that I believe are most applicable to me. Thanks so much for the tips. I'm a new investor. And since I am fresh out of college, and just got my first job, since I'm so young, I'm playing the long game. And I had a couple questions about a couple aspects of investing. In a recent episode, you talked about carbon credits, and I was a bit confused about what those actually are and how to invest in them. I assume they are not concrete. But do they just refer to companies whose main goal is to help with carbon emissions? Or companies who are investing in making themselves more emission friendly, regardless of what the industry they're in? So that's the first part of the question. So let's go ahead, and I guess, tackle that part of it. Andrew, what are your thoughts on that first part of the question?

ANDREW Well, I know we did that interview with Marin Katusa. He was the one who presented this carbon credits idea, gray episode. He's a very smart guy. We recorded it back in August of last year. So go check that out. But you've kind of been going down this energy rabbit hole a lot lately. So I feel like maybe you should lead the answer to this. And I can give a couple thoughts.,

DAVE Okay so I've been working over the last couple months or a couple weeks, I guess, actually, I've been thinking a lot about what kinds of things I want to start, I guess, investigating and learning more about. And energy is something that's kind of interested in me for a long time. And about a year ago, I did some work on trying to learn more about batteries, in particular solar energy a little bit. And so I thought maybe I would kind of revisit that, since it's been about a year or so.

And at the time, I wasn't really able to find anything that I felt like was good investment options, or at least that would fit the criteria that Andrew and I tried to teach. And so I did some preliminary work. And I discovered a few things. So a couple things just throw at you a little interesting tidbit, the electrical grid that we all use to power everything. It's an on demand energy resource. And what that means is, every time we turn on a light switch, the power that we need is now available, it's not sitting there waiting for you to turn on that light switch in your bedroom, or to turn on your computer, as you're trying to watch something on YouTube. It's all on demand.

And so that kind of blew my mind a little bit. And so there really is, at this point, there's really no backup energy storage for the way that we use our power. And the majority of the power that is used right now is actually between five o'clock and seven o'clock at night. And So therein lies a couple of the problems that we're seeing with some of the renewable energy. So there's a couple things that are kind of going on.

So first of all, the energy storage situation right now, with solar in particular, is not where it needs to be, at least on a grid level. On a personal home level, it's probably in a better situation. But on a personal level, or on a grid level, it's not there yet, we don't have the ability to store the energy that is created from the sun when the sun is out. And So therein lies one of the problems is that at five o'clock and seven o'clock it between five and seven at night, especially now, especially here, in the Midwest, it's dark. And so there's no sun and we're not getting energy from the sun.

And so when I need to boot up my computer to watch Netflix or whatever it is, I need another source of energy. And of course there is hydro and there is wind and those do obviously work and the off sunlight hours. But again, there is depending on where you are in the country, you may not have access to that. And so that's why there is some, I guess hiccups with what's going on with energy creation and moving to renewables as quickly as Maybe the politicians and some of the media would like us to get there, we're technologically we're just not there yet. So what's happening is, is that we have to rely on other forms of energy that are not as clean, and are not as politically friendly, ie natural gas and coal in particular. Now, depending on where you live in different parts of the country, there may be parts of the country that may use more coal to make up for that shortfall than natural gas or other resources.

So currently, right now across the United States, and don't hold my feet to the fire on the exact percentages, but around 30 to 40% of all the energy that's produced right now is natural gas. Depending on the part of the country, it's 15 to 20%, coal, and then there's a us about 15 to 20% of nuclear, and then the rest, it will be filled in with renewables of a variety of sources, whether it's wind, solar, or hydro. And again, depending on what part of the country you live in, those percentages may be a little bit different here or there. Another interesting tidbit NextEra Energy, a company based out of Florida, which is a utility, they are the largest producer of renewable energy right now.

But even they who are the largest producers of renewable energy, are getting almost 10% of their energy source from coal, and are getting around 50 or 60% of it from natural gas. So even they who are the largest creators of renewable energy still are not at the point where they are able to really have a big part of it being renewable. And again, the majority of this comes back.

ANDREW So is it fair to say that to use another baseball analogy, the push to renewables is very much in the early innings. And so there could be a lot of big kind of movements or uncertainties, not only around carbon credits, but the whole energy situation in general?

DAVE Yes, absolutely. It's definitely in the early innings. The technology to create, the amount of energy that we need is absolutely there. I'm reading this great book right now called the grid that's basically about the electrical grid here in the United States. And they've been talking a lot about how energy is produced. And there is no doubt that we're producing enough energy from a renewable source like the sun or even the wind that will be able to power us the biggest issue is that we don't have a way of storing that energy right now that's economically viable.

There are batteries out there, Tesla is one of the companies that are making some of these bigger grid batteries, they just don't have the storage capacity to get us where we need to go. And so that causes some bottlenecks on how we produce the energy that we need. And until that technology catches up, I think that's going to be a struggle for us to really move towards that. The energy, I guess, renewable energies, sufficiency that we really want, you know, as a nation, and as a world, and so we're just not there yet. And it doesn't mean it won't be in a few years, the rate of change and technology, as we've seen with the semiconductor chips is just astounding. And some of the same laws apply. Anyway, so all that to say, there is a lot of energy that's out there that's being created.

Unfortunately, we're not at a point where the renewable energy is where we want it to be. And that's kind of where the carbon credits start to come into play. Because what happens with the carbon credits, and Andrew, correct me if I'm wrong, but companies that want to create, maybe greener sources of energy, as well as greener sources of economics, are creating green bonds that they are selling to companies that maybe aren't producing as much carbon, there may be producing more carbon credits as they want. And then they kind of

use that as an offset, to try to help create more opportunities for those companies. And if I'm speaking incorrectly tell me

ANDREW it's like two parts. So the carbon credits is the thing that is bought and sold. So if I'm like an Exxon, and I'm very dirty, and there's another company who's basically able to be a net positive to carbon instead of negative. So an example would be like, if you're planting a bunch of trees, and you're able to capture the carbon, then you're like carbon positive here, you're helping the environment.

So the government will give you the carbon credits, and then you can sell those to Exxon. And the next song can make their account whole. The second part of is the green bonds, which is companies who are carbon, they have a certain carbon score, they're able to get cheaper access to the bond market, which makes it easier for them to grow, because they have this cheaper source of capital.

Those are kind of the two big themes that if I remember correctly, from our conversation with Marin could provide a lot of investment opportunities if you know where to look. I know for me personally, I stick to what's established and what I can see. You know, when it comes to companies with stable cash flows, and something that's very much in its infancy is hard to predict for anybody So for me, I stay in the early innings of that. The opposite of that. So for me, I stick to the more established free cash flow generating companies. And I have no special insight into those in the early innings.

DAVE Yeah, I don't either. Really. I know that in my readings of different companies and whatnot, I am coming across different companies that are maybe mentioning that they have green bonds available. And I know Google was one of the companies recently that talked about a green bond issuance.

ANDREW And I come America to believe it or not, yeah, Bank of America,

DAVE I would bet a lot of money that Microsoft has probably embraced to that idea as well. I don't know, I don't have the hard facts. I know, this is speculation based on what I know about the company. But I know that Google at the Bank of America too, for sure. And I would think that if you did a little Google research, you would probably be able to find some resources out there that would talk more about that extensively.

ANDREW I know, this is something we've discussed before to not on the air, but there is some of that kind of being pulled back as government spending gets shifted. So there is a additional risk just because companies are free access to if you don't call it carbon credit capital, there's no guarantee that that's going to happen in the future. So you do have to tread carefully.

DAVE Yeah, exactly. It goes back knowing what you own and knowing what you're buying. And it's a little bit like, because some of this is in early innings. I'm not saying that all the companies out there are doing this, but you want to do a little research before you actually put your hard earned money behind something that may not be what you believe in. Because there would be nothing worse than a company that's promoting some sort of carbon emission reductions or carbon credits, or a green bond.

And it turns out that they're not embracing that idea, given that we're talking about Wall Street, he wouldn't be surprised if there's a shady character or two out there trying to take advantage of a situation like that. And so again, it comes back to knowing what you own and doing a little research to ensure that what you are buying is the same kind of goes the same with the ESG ETFs that have been such the rage, you want to make sure that you're not buying an ESG ETF, the top five companies are BP, Exxon, Mobil, and at Home Depot or something, you know, that just are completely against everything that you're trying to invest in.

So they're great ideas. And Maren was very bullish on the whole idea. And he wrote a great book about it, as well as the podcast, are great resources to learn more about it, if that's something you're interested in, and he thinks it's going to be one of the more profitable trades that you could embrace over the next few years. So it's definitely something if you're interested in to learn more about it, check out that episode with Maren

ANDREW Yeah, it was a great introduction, all of that good, basic, you know, foundation on how to think about energy. I think it's not he got really into the weeds. So I think he did a good job of at least giving us some context there. And it's good advice for people to think about.

DAVE Yeah, I could definitely get in the weeds on energy. But we'll we'll move along from that. I don't want to bore people to death. All right, the second part of this great question here. So also, since I'm a beginner, and looking for good long term stocks and mutual funds, that jargon and important statistics are still a bit daunting.

I'm sure they'll go away with time. But for now, what couple of metrics do you feel are most important when researching a company to invest in? I know that everyone's approach and personal weight to each metric varies, but I'm just looking for a stepping off point. Any advice is appreciated. Thanks. So Andrew, what are your thoughts on the metrics? For the second part of the question,

ANDREW I would always start, especially if you're a beginner, start on the price to earnings ratio. And it's not trying to tell you what a company is worth necessarily. It's just trying to give you a point of reference. So I'll give you an example. If you go try to buy a car right now. Good luck. First of all, there's huge shortage. And so as a result, the used car prices are a lot higher than they used to be. I mean, I've heard stories of people who are selling a car that they bought brand new and getting more money out of it than they did when they bought it brand new. So it's kind of like the state of affairs in the used car market. And so if you think about, like, if a dealership selling a car for 30, grand, and the KBB, which is kind of like, I don't know, how would you describe KBB to somebody who doesn't know what that is?

DAVE It's kind of like I guess the the manual or the go to guide to give you I guess guidance on what would be fair prices for different statuses of your car.

ANDREW Yeah, perfect. So kind of fair value estimate for cars. And so if you were to compare a car at a dealership, and if one dealership was selling a car at I don't know 35 grand and the cars KBB is 30 grand and then you compare it to a dealership selling a car for 40 grand the KBB 39 grand, you kind of know which car would be a better deal based on its relationship to its KBB. You can think of the same kind of logic with the price earnings ratio where it's not so much that we're saying, oh, man, this car is 50 grand. So it's expensive. It's like, well, compared to its value, it's actually pretty decent.

The price earnings does the same thing in the stock market, because it compares to the earnings of the company generates and compares What's the price of the stock market for that stock, and compare it to its value in that way. And then all the ratios, all the metrics kind of form some derivative of that. And so, you know, it's frustrating, I don't think I'll ever end It's a common misconception. But when you say a stock's expensive, we don't mean you have to pay $1,000 to buy one share, we mean in relation to its actual value. It's either cheap or expensive, and that I would start with the price earnings ratio, what would be a couple of derivatives from that that you would recommend to somebody starting?

DAVE Boy, that's a good question, I guess a couple other places I would look would be one would be return on equity. And the other one would be return on invested capital. Now, though, return on equity is a really easy way to measure the profitability of a company, as well as how well it generates returns for shareholders. Because the basic way that the metric is set up is you look at the net income or the earnings of the company,

and you divide that by the shareholder equity of the company. And if the shareholder equity grows, and the earnings grow, then you will generate more value for us, the shareholders or stakeholders, people that are involved with a company.

And so that's a great profitability ratio that you can look at. And so that's something that it kind of ties in with the earnings, because they're kind of related, because the earnings is the, the measure of the price to earnings. And that's how you're determining the value. So you look at the value of a company, but then you also want to look and see how profitable the company is, and how well they do reinvesting those earnings to grow more value for the company. One of the things you have to think about what the stock market is, even though Apple has created a fantastic investment in a product in the iPhone, they still have to reinvest in the company to generate more profit farther down the road, whether it's creating new products, like the eye watch, or the earbuds, or whatever it may be, or even upgrading new versions of the iPhone. And so all that money has to reinvest.

And that's how the company grows the business. And return on equity is an easier way to measure that profitability. And if you see those kinds of metrics growing, so if we're turning equity for a company, let's say grows from 10 to 12, to 15%, over a three or five year period, that's awesome, because that means that the company is generating more revenue and more growth of the company by reinvesting well, and one of the jobs of a CEO. Well, that probably the arguably the most important job for a CEO is to grow the value of the company, for shareholders, not for himself, but for shareholders.

And using a metric, like return on equity or return on invested capital are great ways to measure how well the company slash the CEO uses the money that they generate to grow the company. And so I guess in comparison to price to earnings return on equity is a good one. I think

ANDREW It's a really a perfect complement. And I think if that definition of return on equity is a little bit still unclear. Todd Wenning did an interview with us several months ago, and he had a really boiled it down like as if I was a five year old, I could understand it. So that's a great one, he's talking about return on invested capital, you can use that logic on return on equity as well. And you know, you never want to like simplify things too much. Because sometimes the devil can be in the details.

But if you really looked at Buffett's approach, and he's talked about it, I mean, his two big things when he looks at price and then the value of a company really comes down to like the price compared to earnings, and then also how they reinvest their earnings and return on equity. He's talked about return on equity all the time. So there are different derivatives that if you're more advanced, you can move past price earnings return on equity, the price to free cash flow, which I use as a screening tool, that would be the next logical step after price earnings. And then ROIC which you mentioned, return on invested capital would be the logical next step to ROV.

Those are really fantastic places to go. When you're trying to kind of get your senses around how the market why stocks are being priced a certain way kind of how the quality of those stocks are. And then that's always a starting point.

You never say I'm gonna buy this company because it has a low P E. I mean, that's a disaster. It's pretty common and you got to do a little more digging than that if you want to pick stocks yourself.

DAVE You absolutely do. And I think another great idea to think about when you're looking at metrics and starting to try to get an idea of how they work and their relation to the financials of the company, is to think

About they're considered in finance world relative valuations are relative metrics. And the reason for that is because they're relative to other companies as well as to the performance of the particular company.

In other words, you don't want to compare the P E of Aflac to the P E visa, they're not in the same universe, they operate completely differently. And it's a complete different kind of relationship. And people are more investors are willing to pay more for the earnings of visa than they are for Aflac. And it doesn't mean that either company is a better investment or a worse investment. But it just means that relative to each other, they're not comparable. So a better comparison would be to look at the PE of Visa and MasterCard, as opposed to visa or Aflac and Aflac, in case you'd want to look at the P of Prudential or State Farm, or Allstate, and that would give you a better representation of how expensive or cheap that company is relative to its industry.

And so that is a very important aspect of looking at metrics. In particular, the P E ratio, it's same applies to the price to book the price to sales price to free cash flow, any of those price related metrics, you want to compare them to interest companies that are in the same industry or same sector. Otherwise, you're setting yourself up to pull the trigger on something that may actually be beaten down for a very good reason, because it's the company's in the crapper. And you don't want to invest in this.

Likewise, you could be buying something that's super expensive, and relative to the value of the company. And so that's a pro tip, if you will, to help stay away from over exposing yourself to companies that may be expensive, or maybe too cheap for a reason. And so I think that's a great thing to keep in mind. Also, keep in mind that price to earnings, as well as any other metric are shortcuts to valuing a company. But when you talk about price to earnings, you're not valuing a company, you're looking at a shortcut to value the company. And to value a company, you have to look at the cash flows of the company, you have to go a lot deeper than what we're going to talk about today.

Because that's definitely a little more advanced stuff that I don't want to throw people off the scent, but a price to earnings in return on equity. All those metrics are great price to free cash flow. They're all great. But keep in mind that you need to use them relative to other companies as well as the performance of its own company.

ANDREW That's a perfect way to kind of tie it all together. Going back to that example between Aflac and visa something about insurance companies, they have to keep more cash on inside of the business because if 100 People get in an accident, for Aflac, they're gonna have to come up with that capital. So actually, the government actually regulates that they keep a certain amount of cash in the business. Whereas VSA needs very little cash to run their business.

I mean, their network, their rails, they run continuously and with very little reinvestment. And so if you look at the ROI, the return on equity for each industry, it's very, very different. And that's why you get the higher P E for something like a visa because it's a lot easier for them to grow and they have lower capital requirements because they have higher ROP and similar thing to Aflac.

So kind of getting those two kind of balancing concepts together. You can see how it tends to be really tied in a lot of industries and explains a lot of the reason why you do see these discrepancies in price earnings and some of those other ones.

Alright, folks. Well, with that, we will go ahead and wrap up our conversation for today. I wanted to thank everybody for taking the time defend, send us those fantastic questions, please keep them coming. We enjoy answering these questions that help give you guys a little bit better insight into how the stock market works and how you can make your money work for you. 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. I'll talk to y'all next week.