IFB226: Unlocking the Different P/E Ratios, Cap-Weighted vs Equal Weighted Indexes, and the Business Development Sector

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All right, folks, welcome to Investing for Beginners podcast. Tonight we have episode 226. And we're gonna answer three great listener questions we got their kind of a wide range of conversation. So this would be an interesting episode, folks. So buckle in. So here we go. I'm gonna start us off; we got Hi, Andrew. Sorry to bother you, never bother. I have a question I'd like to ask recently. Well, we're starting companies. I've noticed Yahoo Finance and other sources are using non-GAAP P E ratios. For example, I've been looking at BM why recently, and Yahoo they have a forward P E of 7.6. I looked in; this is non-GAAP.

But when looking at Gap, it's in the 19 regions. I've had to work out the gap earnings. Why is this? Should they post GAAP PEs and not non-GAAP? Any thoughts on this? Thanks. So, Andrew, what are your thoughts on this really interesting question, which could take us in a lot of different directions.

A

Andrew

0:57

So let's start by defining PE and GAAP. So first, PE is a great ratio for all investors to know; definitely, if you're first getting started, it's probably one of the easiest ones to get a grasp on. It stands for the price to earnings; it is comparing the price of a stock to how much it earns. So in simple terms, you can think of Apple's trading at $172. I don't know what their earnings per share are at the moment. But if it was, let's say, $172, their PE would be one, right? If it was, you know, $200 stock price $50 in earnings per share, their PE would be four. So that's how you do price to earnings. Now the GAAP part is standing for. That's an acronym; I'm not going to say it. Its accounting principles are generally accepted accounting principles, and it's a standard. So it basically means you're conforming to the rules of accounting strictly and precisely when you use GAAP earnings.

So he mentioned that Yahoo Finance, when shows the forward P E ratios are not GAAP. So by definition, you know, a lot of these websites will have forward P E ratios. So most price-earnings ratios are calculated by looking at what the company has earned most recently and using that as your earnings in the formula. When you do a forward, you're just taking that, and you're trying to project what the future earnings are supposed to be. So analysts for most companies will have projected earnings. And so that's where they will get the forward earnings from, and yes, those will never be GAAP because they're not real; they're projected. And so that is why you will see different PE ratios on different websites. And you have to be careful because some of them might say, Yes, this is a forward P E ratio; some of them might not like it might just display the PE. So I think that's a good example of why you do kind of want to at least understand how you can calculate that formula for yourself. Like, you know, if I was a new investor, I'd never calculated PE before. How would you recommend I go about that?

D

Dave

3:12

How would I recommend you go about doing that? That is an interesting question. So I think the easiest way to do it is, I guess, there are several ways to kind of think it through. The first is to try to find a website that will provide you with the current stock price of whatever the company is because that's going to be part of the equation, obviously. So the first thing you're going to look for is what the company is selling for whatever it may be, whether it's CVS or apple. So you look for whatever the company's selling for. And then you would look for an I think the easiest way to do it is to look for another website that's going to tell you what the earnings per share are so that you can kind of calculate it that way because then you can take what the earnings per share are and divide that by the price. And that will give you the price to earnings the other way divided by Yeah, price. I'm sorry. Yeah. Yeah. So it'll get confused.

Yeah, so don't get confused. That's probably the air quote. The easiest way to do it. If you want to what websites? What websites? Well, there are lots of them. Probably my favorites, if I had to choose, would pick one stratosphere investing. Our buddy Braden has this great website called stratosphere investing. And that is a great place to go and find the P E ratio of a particular company. And he does list them by current PE as well as trailing P E as well as forward P E. So they will be listed out there so you can see the differences. And a little side note, if you're looking at a price to earnings ratio, that is one of them, I guess, beginner ratios that people use to measure a value of a company by looking at a P E ratio. And generally, the lower the price to earnings is; generally, the more undervalued the company may be. It's, again, a generality, but that's kind of the conventional wisdom; a great way to look at that is to compare that to other companies in the same industry; that's called a relative valuation. So if you want to get a sense of whether Walmart, Amazon, or Costco trade compared to each other by looking at their P E ratios, that can give you a potential sense of whether one of those companies is cheaper than the other, based on their earnings and the price comparison of those. It's very important when you're doing something like that, however, to make sure that you're comparing apples to apples.

And by that, I mean, if you look at the forward P E of like, BM y, and it's 7.6. And then you look at a current P E of a competitor, and it says 19, you're obviously going to think that BM y is way cheaper, and think, oh my gosh, this is the company I have to buy. Unfortunately, that could be misleading. And so that's why it's very important when you're looking at comparing companies like this. When you're looking at ratios, make sure that you know which ratio you're choosing. If you're going to compare forward, P e is fine. No problem. Same with trailing Pease, which means that P e is that happened in the past, or if you're looking at something that's more current. So it's very important to make sure that you kind of stay on top of what he is looking at.

And it can be very confusing. As Andrew said, there are some websites out there that won't always tell you exactly which one it is they're listing,

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Andrew

6:38

that's a really great way to put it. And the last thing I'll just add to that is what company you're getting also plays a part. So I would rather pay a higher P E for a company that's growing than a low p for a company that's shrinking. And even if we're talking about one that's growing faster than the other, it's a similar kind of discussion. So I would start with the P E and try to figure that out. You know, he asks, Should they post GAAP PS and not non-GAAP, it's not like bad or good. It's just It's good that you understand that the four P is non-GAAP.

And so, for me personally, I like to rely on more of the present PE or trailing P E, current PE, whatever you want to call it. That's a lot more reliable to meet, and the Ford P. And I think the listener has that same kind of idea. So that's very good. D

Dave

7:32

Yeah, I want to touch on one thing I'd like to get Andrews's input on. So when you think about a forward P, what does that really tell you as an investor, like in this circumstance with BM y when you see the default PE is 7.6, which is quite a bit lower than what the company is currently trading? At. So what does what would that tell an investor?

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Andrew

7:53

That's a great thing to touch on. So basically, it's saying that BMI is projected to have a lot higher earnings than they do now. So when you see a PE drop a lot, or even if it rises up really high, it's more likely that's because the earnings are fluctuating. So you know, that could be a lot of different things. If we're talking about the healthcare industry, it could be COVID-related. If we're talking about a super cyclical, it could be, you know, like in the travel industry, they were shut down, and then now they're reopening.

And so earnings are swinging wildly. So when you see big changes in the PE like that between forward and current, it's generally because the earnings have changed so drastically.

D

Dave

8:37

That's very well said; okay, that makes a lot of sense. All right. So let's move on to the next question. I have. Hi Dave. As always, I love your podcast, and thanks for bringing us new current content. I have recently been reading a lot about different types of indexes, specifically fundamental indexes and value-weighted indexes, compared to cap-weighted indexes; I was hoping you guys could talk a little bit about this or give me some insight as to whether the books I'm reading are misleading or not. I've recently read the fundamental index as well as the big secret for the small-time investors. Both of these talks about the problems with the CAP weighted index, and I'm trying to figure out what path I should take as a predominantly index investor from my research. The problem with CAP weighted index is the overweight, undervalued companies, and underweight undervalued companies, especially in bear markets, which hopefully knock on wood.

We aren't maybe hitting into as always. I appreciate your thoughts and comments, Ben from Kingston, Canada. So got we got somebody from the Great White North asking us a question about indexes. What are your thoughts on this really good question?

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Andrew

9:43

Sweet. Yeah. So let's start, I guess the different types of indexes. So you have the fundamentally weighted index, I believe it was called. So an index is a basket of stocks, right? Just all put together, and you can buy the index of having to buy like 2050 100 With 500 different stocks. So if it's fundamentally weighted, that means that they are taking some sector of fundamentals and using that to build the basket. So that could be low p e ratios as an example. And that could be a low P E ratio index. So that's one type of index he mentioned is the cap-weighted index, so it's short for capitalization or market capitalization-weighted index; an example of a market capitalization-weighted index would be the s&p 500. So the difference is that those businesses are all of the different sizes. So they make up a different percentage of the portfolio. For example, Apple is several trillion-dollar company. And so that right now, actually, they make up 7% of the s&p 500, whereas some of the much smaller, like United Health, which they're actually not that much smaller, but they're in the hundreds of billions instead of trillions, they only make up 1.3% of the index, and you have the 490 other companies that are smaller than that, that make up less than 1% of the index, that's a market capitalization-weighted in contrast to equal-weighted, which means that if we took that same basket of s&p 500, companies, they would all have an equal piece.

So you divide by 500, each company makes up that same amount. So there are pros and cons to each idea, the pros, and the cons; let's start with fundamentally weighing them. I guess I'll start with the cons because those just jump out at me. And there are obviously pros; I think Ben says he's an index investor. And so I think he probably knows the pros, some obvious pros, you get that diversification is really nice, you have companies that can really help drive the index, especially the more of them you have, that can be helpful as well. And it's a lot less work to just pick one of these rather than picking the different companies; those are all great positives, some of the negatives, the fundamentally weighted index, where they are strictly looking at a company's numbers, and nothing else good gets you in the stocks that maybe you don't want, and the rest of the market doesn't want.

So, for example, tobacco companies have traded really, really cheap valuations for quite a while because people don't like the idea of putting money into something that's killing a lot of people. That's one example. Or they just simply see that in the long term future the trends of smoking are going down. So the future growth potential doesn't seem to be as great. There are other companies like, I'm not going to like call out the

name of it. But there's one that, to me, looks like a multi-level marketing pyramid scheme. And other investors have kind of called that out. And so you look strictly at the numbers, it looks like a fantastic business just like crazy earnings, crazy growth, and it's cheap, super cheap.

But you know, How sustainable is that? Can the numbers actually tell you that if the government comes in and says this thing's a scam, and then it goes to zero? So those are some of the downsides of only looking at the numbers. And that's just what's going to have to happen if it's really a fundamentally weighted index. Do you have anything to add to that?

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Dave

13:18

No,A

Andrew

13:19

I don't. I think those are all great insights. Keep going. I want to hear what you think about CAP weighted. Okay, cool, the cap-weighted index. So there are pros and cons to that, too. This is a con of CAP weighted market-cap-weighted indexes. Yes, they will go overweight, the more overvalued companies and underweight the undervalued companies, just from a general standpoint, just because as a company becomes more overvalued, it becomes bigger. And so the index is allocating more money to that our favorite company Tesla has a super high P E ratio. And it's number four in the index. Now it makes up 2.3% of the s&p 500. And the bigger it has gotten, the more that people who are buying the s&p 500 index are getting Tesla shares to have; that's a potential con if the index gets bloated with a bunch of those kinds of companies.

Another phenomenon that's really similar to that which Buffett's actually touched on before was this idea that if you're the take a snapshot of the top 10 companies in the s&p 500, in 19, even though they said in 2000, it was either 19 or 2000. So just 20 years ago, not even that long ago, if you were to take a snapshot of those top 10 biggest companies in the s&p 500 and you compare it to today, there are, I think, just two companies that were there in 2000. Now they're still there today. And so what it tells you is, it's really hard to stay near the top. So you have a lot of forces going against you; you have the fact that, like as a company, there are the skies At the limit, you can't grow bigger than the economy, you can have competitors coming out to you at all angles, lots of things that make it difficult. And the bigger you get, that almost can become, like a weight, like once you're at 500 billion in revenue, you could have 50 billion more in revenue. And that's really hard to do. And that's just to get to 10% growth, right? It's not easy to scrape around 50 billion in the year. So that's a problem. I guess the upside to that, though, is you do get really great companies too.

So not only are the companies getting bigger, sometimes they're overvalued, but sometimes they're fairly valued. So you have pros and cons with that. And that's something that I think is no easy answer. And I think depending on what part of the market cycle you're in if a market cap index is going to be better, it's probably going to perform better in the future. But sometimes, when those cons really get out of proportion, then in those cases, those kinds of indexes will probably underperform in the future. And nobody has a crystal ball. So we can't tell you when the best time to buy those or not buy them is.

D

Dave

16:09

Yeah, exactly. I love all those explanations. And he did a fantastic job of kind of weighing that out and talking about some of the downsides, the potential downsides that could come from investing in investments like that. And like any investment out there, there's going to be a good side and a bad side, you know, the dark side of the force. And those are things you have to be aware of, and you have to know when to know going into it because there is no risk? Well, there are risk-free investments. But those are also the risk on that part of it is you're not going to get the greatest return. But would you use index funds? I guess one of the advantages for a guest working around a question like Ben was talking about, as you have so many different flavors now of different kinds of indexes that you can choose to help you find something that's going to meet your risk tolerance, as well as what you're looking for, for your returns. And there are lots of opportunities out there. And I will say the idea behind a fundamental index could be dangerous because sometimes those companies are cheap for a reason. And we always have to kind of keep that in mind.

Yeah, it is cheap. But there's a reason why it's cheap. It's it should be because maybe the company is not growing, or they've had some management malfeasance, or there's been some scandal going on with a company, or they just are operating in an industry or a field that is dying. And there's just not much growth there, potentially. And so, those are all things to keep in mind. And I guess the other thing to kind of keep in mind, too, Andrew kind of touched on this, if there's something that you don't want to invest in, one of the things about investing in index funds is understanding what's under the hood. So try to there are lots of resources out there to be able to determine what companies that index is investing in, along with the things that Ben mentioned in his great question.

You can look@etfs.com, for example, and they will list all the companies that are in that index or the ETF for you to be able to determine; let's say that you don't want to invest in tobacco like Andrew mentioned earlier, then if you find an index that you really want to invest in, and they have three tobacco companies, then you can avoid that ETF or index. So there are a lot of great resources and a lot of options with that to help you, you know, find it, the investments are going to matter to you and make an impact on what you want to make an impact

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Andrew

18:33

On that as well. So I mean, as much as the market-cap-weighted indexes can have their downsides. If you're really looking for a big time saver, a big, I don't have to think about it; I'm just gonna have somewhere to put my money and just let it grow for the years. The s&p 500 index, which is a market-weighted index, is probably your best bet. Because you can just literally just buy it and not have to think about it. So if you want the easy route, that's the easy route. To dig into the weeds. That's what we're here for.

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Dave

19:06

Right, exactly. And as far as the books that Ben mentioned, I personally have not read those, and I wasn't familiar with him. But again, ETFs and indexes are not my forte. So it sounds like those books are probably pointing you in the right direction. So I think I would, you know, take what they're teaching you and try to apply it to what you're doing. And hopefully, our question helped answer some of your questions as well. All right, let's move on to the last question we have here tonight. So this is going to be a fun one. So we have what your opinion on dividend stocks is? Like PSEC and HTGC? So this was an interesting question because you guys always seem to throw questions at us about industries and sectors that we are not familiar with. So this forced us to do it or research, so that's actually kind of fun. So we appreciate that. So alright, so I'm going to talk about my first accompany so I'm going to take the HTGC Company.

So, again, this was a company that I was not familiar with. But again, there's, I don't know, 8000 public companies out there, so we're not going to know all of them. But alright, so here's kind of, I guess, my initial take on the company. So, first of all, not a big company; it's not a small company with a market cap of around $2.1 billion. So it's definitely in the size that I would want to see. But Hercules capital, which is the name of the business, is a business development company. So some of you are out there probably asking what the heck is that. And I admit, I had to ask the same thing. So looking at their 10k, yes, we read the 10 Ks; basically, the company is a finance company is kind of the easiest way to describe it. They provide loans to people trying to start or grow a business.

And one of the things that both of these companies seem to focus on is kind of filling the niche between banks and businesses. One of the things that Andrew and I were talking about off air, which was kind of interesting, about kind of thinking about these companies is that they kind of function like banks, but they're not necessarily banks. They are businesses that loan money; in this case, it is Hercules capital; they loaned money to venture capitalists. So those are private investors that are starting to start a business or are investing in other businesses. And so Hercules capital basically helps them bridge the gap between the cash that the company that they're investing in can or can generate and providing funds for that particular business to continue to grow, whether that's reinvesting in the business, buying property, equipment, r&d, whatever that company may need, Hercules capital is easier for me to say, they will help provide that funding.

One of the things that are going on in the finance world is banks right now are not necessarily lending to people. And that has been one of the struggles for businesses. And it's kind of a timeless struggle, sometimes. But particularly since the great financial crisis. And particularly since COVID happened, banks had been kind of stingy about loaning out money, especially to businesses and small businesses, because they feel like they're riskier investments. And so they've been hesitant to loan out as much money as they probably should. Therefore, these business development companies are kind of sliding into that gap and providing funding for these smaller businesses. Now, we're not talking about a small business, like, you know, I don't know, trying to think of somebody that you know, maybe a ten or $15 billion company, we're talking about very small companies like less than a kind of ranging between 5 million to 100 million in sales, or 5 million in market cap to a billion in market cap. So these are small, small, small companies that these business development companies are kind of beating the need for those companies.

So that's kind of what at least Hercules capital does. Hercules Capital focuses more on technology companies; that's their focus of the business. And so if you look at the financials of the company, just kind of briefly, I'm not going to go into a whole host of numbers for you, you can look and see that the revenues for this particular company have grown decently, and they pay a great dividend. And I think that's probably why this person is asking about these companies because these companies pay well; in particular, Hercules capital plays a fantastic dividend, they pay 100% of their earnings as a dividend, and their yield is over 7%. So that's, that's quite high. And so that's very attractive in that regard if it can be sustained. And so those are

just, I guess, a couple of quick overviews of that company. Andrew, would you like to chat about yours for a second?

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Andrew

23:55

Well, do you see any risks for Hercules when you look at the big picture of the financials?

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Dave

24:01

Yes. So if I look at the big picture of the financials, I guess a couple of things that kind of stand out to me; when I look at the balance sheet, it basically consists of three items, long-term investments that the business makes. So, in other words, they're taking extra money that they make, and they're investing it in other things, i.e., bonds, or savings accounts, or maybe real estate or something like that, in an effort to earn money, then they also have data that they've taken out to try to have money to offer to these businesses as wounds because the company has not been generating enough cash flow up until recently to do that. And so, if I look at the balance sheet, it consists of basically three things. It concerns the company's debt, the investments that they're making, and the capital that they're taking from the debt that they're taking on.

Because they're worth Ain't earnings and their common equity, have actually been kind of low. For the last few years, it started to pick up a little bit. But I guess as they're taking on more debt, and they aren't generating a lot of cash flow up until recently, that is a concern. For me, at least as a, just to kind of a general overview of this business dividend great. The business need, obviously, is there for them. And it's, it's been around since 2003. So it's got, you know, a decent track record. So, I mean, those are encouraging things. But I guess that's kind of my high-level overview of that, of that company.

A

Andrew

25:34

That makes sense and kind of works like a bank in the sense that it seems like their debt is a high percentage of their balance sheet. And you won't see that more traditional type of company. Yep, yep, exactly. Cool. Well, I'll talk a little bit about the PSEC ticker; I don't have as great of an overview as you did. But luckily, it's in a similar type of kind of company. It's also a business development company; the company's name is Prospect Capital Corp; where they differ is, they take a large percentage of that kind of long-term assets that Dave was talking about. And they turned them into control company investments. So a big percentage of the company's revenues and assets are made up of these control investments; it's almost half. So I kinda like to think of something like this, if you've ever watched the show Shark Tank with Mark Cuban, they'll have these deals with these entrepreneurs, and they'll say, I'll take a certain percentage of your company. Plus, I'll give you, you know, $2 million in the loan or something like that, right.

So it's a similar, similar kind of situation where if they have control a control investment, they have enough of an ownership stake in the business that they're lending money to, that, not only do they get the upside of collecting the interest on whatever the loan is, they also have these investments which have value. And so you can participate in that upside from loaning money to the company. And then, if that company grows, your investment value grows. So one of the risks that I saw they mentioned in the 10k they talked about how market moves can affect the value of those control investments. And so, since that makes them a big part of their balance sheet, it makes, it could potentially have a huge impact on how the numbers in their financials look as the market goes up and down because markets tend to move together, whether we're talking about private equity, or the public markets, like the stock market, when valuations go up, they tend to go up everywhere, and vice versa, when things are tough. So that's something I think that definitely kind of puts this company apart, as well as the HTC.

They're about these business development companies. So it's kind of hard to really look under the hood because you don't necessarily know which companies that they're lending out to; even though they might be disclosed, you don't have that same ability to look at each individual company, like management for these companies are. So you do have to put a lot of faith and trust in the people who are running these companies that they will make good investments and make good loans. And so that's something that I think is a very important thing to look at if you're looking at a BDC.

D

Dave

28:35

Yeah, exactly. That idea applies to just about any company that you would ever invest in is understanding the management and having faith that they're going to do right by your capital because when we invest in a company, we are giving them our hard-earned money to use to operate their business. And if they're not giving us the returns that we earn, or we deserve, then that's for us to decide whether we want to continue to be invested in that business in that person, or people that are running that company, a couple of things else that I kind of wanted to kind of take on a little bit about kind of these ideas of these business development companies. One of the things that could be a potential boon for the companies is a majority of their income is earned from interest on the loans that they're giving to the people in these businesses. And the way that they make money on those is on the spread of the interest rates. And what I mean by that is when Hercules capital borrows money, let's say a 2%. They're paying the bank back at 2%. So that's how much the money cost Hercules capital. If they loan it out to me at 5%, then Hercules capital makes 3% on that loan because that's the spread between the money that I'm borrowing and paying them back versus the money. They're borrowing from Bank of America, for example. And so that's how that's in general how banks make. Oh, a lot of their money is by that spread of interest rates. And the lower interest rate that a financial or another bank will borrow is in large part based on the Fed funds rate, which is set by the mechanism of different things. And right now, they're talking about raising those rates because of inflation; that's one of the ways that they try to control inflation is by raising the rates and slowing down the economy.

And so as those interest rates go up, that means that BDC, like Hercules capital, in theory, could loan money out at a higher rate to me because now they're going to be borrowing money at a higher rate, and they can lend out money at a higher rate. And depending on what credit scores and all that fun stuff, you can see higher rates being lent out at, which gives them a bigger spread, which means there's a potential for a financial, like a business development company or a bank, to make more money as rate as interest rates rise. And so that's why you'll probably see as well, just as an overall general trend, banks are starting to do better in the markets because the interest rates are starting to come up. And that's one of the ways that they generate

income. So there's that kind of idea to think about. The other thing I wanted to mention, too, is probably some of the attractions to these kinds of companies is the high dividend yields that they pay. And something to consider when you think about investing in dividend companies is understanding whether that high dividend that they're paying you is sustainable. And so one of the things that I mentioned about Hercules capital is that they're kind of on the edge of paying out everything they make as a dividend. And as an investor generally, yeah, that's, I like that course, we want to, you know, we all want to get as much money as we can. But you also have to realize that they're in business to operate a business.

And if they give me all the money, and they have nothing else left for them to grow the business, then that doesn't really help me much. And so when you see high dividend yield companies like these two companies, then that's something that you want to do like an extra layer of a little bit of research to discover whether or not those kinds of dividend yields are sustainable, because of a company's taking on extra debt. Or if they're diluting, in other words, selling equity in the business to generate money to give us a dividend. In the long run, that's not sustainable. And so that's not really something you really want to do; this is something I would choose to get involved in. And I would encourage other people not to get involved because over the long run, 510 2015 years in that timeframe, that's not sustainable. And the businesses go out of business if they, you know, at some point, and that's not what anybody wants. And I don't want people to get involved in that kind of thing.

So that's something I would encourage people to look at when they see some of these high dividend yield companies to determine if it's sustainable or not.

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Andrew

32:56

Yeah, that's very well said. I mean, people can't see because they're listening, but like, violently shaking. Like, great, John.

D

Dave

33:05

Yeah, the Drip King is spoken. So. All right. Do you have anything else you'd like to add? No. Okay. All right, folks. Well, with that, we will go ahead and wrap up our discussion for this evening. I wanted to thank everybody for taking the time to send us those fantastic questions; please keep them coming. And it's a lot of fun to talk about industries and sectors that we are not familiar with because it helps broaden our horizons, so hopefully, you guys get some good interest—interesting information from that. And with if you have any questions about anything that we're talking about, obviously, you'd feel free to reach out to us. We also have a website, investing for beginners.com, on which we have this nice big search bar on there. And if you're not sure what a PE is or a forward P e is that we talked about earlier.

There's a lot of great information there that you can find to help you learn more about those topics or anything else that we discussed today. So we have over 1000 blog posts. We discovered that a week ago. So there's a lot of stuff there for us. So hopefully, that helps you. And again, we're here for you to help in any way that we can; we enjoy doing this. 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. Talk to you next week.

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