IFB228: How to Avoid Dividend Traps + ESPP Plans

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D

Dave

0:00

All right, folks, welcome to Investing for Beginners podcast. Tonight we have episode 228. And we are going to answer three great listener questions we got recently. These are wide-ranging. And so this is going to cover a little bit of different territory. So this will be a fun conversation. So without any further ado, we'll go ahead and read our first question. So I have. Hey, Andrew and Dave, I've listened to all your podcasts over the years and came up with a question about careers. How would you respond to our previous episode when talking about the employee stock purchase plan ESPP.

The general sentiment was something along the lines of that's a free 510 or 15% return on your money; I'd probably cash out immediately. Why subject yourself to potential market swings when you have a guarantee? However, I worked for a company that was recommended by Andrews's monthly e letter. And those companies are held by you slash others as they are seen as great future investments. What would you do if you were able to get an ESPP discount on a company you also saw as a great future investment? Thanks, Nick. So Andrew, what are your thoughts on Nick's great question?

A

Andrew

1:06

So let's break it down real quick ESPP. What that means is it stands for employee stock purchase plan, and it gives you the opportunity; most ESPP plans give you the opportunity to buy the stock in the company you work for at a discount. So like you said in the question, you could get free 510 or 15% on your money.

Basically, you tell your company, hey, I want to buy, you know, $2,000 worth of stock. Usually, they have some program where you can buy 2000 Worth, but you're getting a little bit less than what the price actually is in the market. So a lot of times, with those programs, you can turn around and sell it immediately after you buy it.

And you can pick up that free discount that they offer on the stock, whatever that is. So the reason why we say I probably just cash out immediately do not only do you want to reduce volatility, but you also don't want to put all of your eggs in one basket. So you don't want to lose your job, which is your source of income, and lose your savings at the same time. If the company goes bankrupt, that's probably the biggest reason not to keep as much money from a stock perspective in the company you work for. Because if that if things go south to get hit in a double whammy kind of thing. In this situation, I would look at it like I would look at any other stock if it were B. So I would look at how much of this company's stock makes up my portfolio? And how much do I want it to make up? And so, if I can add more to that position and not feel like it's too much of my position, then I will do that. And if not, then just sell it and put it somewhere else.

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Dave

2:50

Yeah, that's great advice. And I worked for a company that offered stock options, but they didn't offer an ESP P plan. So it was I bought it for whatever the value of the company was in the market at the time. And that was also how the company compensated me when they would give us our quarterly match for being involved in the company's 401k. And over a period of time, that position grew to be a bigger portion of my portfolio, which in hindsight was not the greatest idea because what ended up happening is it ended up growing to be almost 40% of my 401k at one point because it was such a big position. And it just kept growing and growing. And then you know what happened, the stock dropped like a rock, and it went from around $55 A share to around 21 bucks a share. And my 401k value plummeted because I had so much of my worth tied up in the company that I work for. And I'm not saying that I shouldn't have all that money tied up in that.

But in hindsight, I should have rotated some of that money out of that into something else. And so, as I built another portfolio, I have never added to that company since because why would I feel I had so much of that company in my portfolio already. Even though the stock had dropped so much, I still was already in it. So it just didn't make sense. But I would agree with what Andrew was saying because you get a big discount on it, which is awesome. And maybe that's a great way to start a position or a portfolio, having that as your anchor. But if it grows to be 30 or 40% of your net worth, and then all of a sudden, the stock does take a fall, like right now what's going on in the market. And if you had a company that fell 30 or 40%, that would suck, or put it another way, let's say you're close to retirement, and 30 or 40% of your net worth was tied up in that particular company and it dropped half of its value six months before you wanted to retire.

That would not be a good position to be in. So there are times and places for contributing to these kinds of plans. And it's definitely something that, as an AU, Overall part of your strategy is definitely something you should take advantage of when you can. But you have to kind of keep it in consideration. You don't want to have all your eggs in one basket, no matter how much you believe in the company, because depending on what's going on in a market can impact your returns. And it also puts a lot of risk in being involved in a company. And you also don't always know how the company is going to perform, you know, let's say you leave ten years from now, and you kind of forget that you have all that money there. And that could be a bit of a bummer, too. So you know, there are other things to consider. But if it's something that you want to start a position with, I think it's a great idea. A

Andrew

5:37

My pet peeve these days. And part of it annoys me because I've made the same mistake when I first started, is putting too much money into a single company. And thinking that you're doing good investing by doing that. And by putting a lot of money into a single company I'm talking about, I don't know, 20% is debatable. But once you get above that 25, 30%, 40%, That's where you really start to go away from what I believe is good investing and more towards the speculative side. I understand people say that Warren Buffett put 40% of his investment into Coca-Cola or into Apple. But Newsflash, you're not Warren Buffett. Okay. Buffett, more, Buffett had been investing for over 20 years before he put 40% of his money into Coca Cola; he had a lot of experience. He also when he put 40% into Apple, he had that all other sides of Berkshire Hathaway, that's not a stock portfolio, you know, like, he bought real companies like GEICO, the insurance the January, right? It wasn't 40% of the whole company that they were putting into Apple was 40% of his stock portfolio, which only made up half of what his overall company was worth, right.

So and I say it because I made a mistake in the past; as I put it, I had 15% and one company, I think I had 15% on like Sanderson Farms, I had somewhere close to 15 or 20%, and Franklin Resources. And those have been two disastrous pics for me in the past that have taken a long time to recover from. And it's very humbling when you finally have to go through it. It projects such a sense of certainty that you think that there's no way you could be wrong on the company that you're willing to bet the house on; it will set you up for a big tumbling down the future. And the way you mitigate that as an investor is you spread it out. So if I'm spread out over, let's say, 20 positions, and they're each making up only like 5%, one of those I could think I'm right on. But if I end up being wrong, it doesn't kill me.

But if you are adamant that you're right on the 25% position, and you are wrong, you're gonna be playing catch up for a long time, if not for decades. So you do have to be very careful that not only you know, it's easy to kind of like push that kind of simple advice aside and think, Oh, well, I'm smarter than that, or this company is just that much more special. But there is a lot of hubris in that, and you have to be careful.

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Dave

8:11

You absolutely do. And you have to look no further than what happened to Netflix yesterday, which dropped 35% in one day. And Andrew and I were talking about that off the air. Before recording tonight, I don't know that I've ever seen a company that size lose that much in that short amount of time. It's kind of staggering. And I would imagine that you know, everybody, prior to what happened yesterday, though that Netflix was kind of a no-doubter. And for me anyway, I can't speak for the rest of the market, obviously. But it kind of shocked me a little bit to see a company like that go through what it went through yesterday, and probably will continue to struggle here for the next little bit until they can prove that they can grow revenues and subscriber counts again, until then people are probably going to put it on the big delt bus.

And so anyway, if you work for a company like that, and you think that it's super, super strong, and nothing like that could ever happen. Just try to remember what happened on Netflix, and I'm not bashing people that are investing in Netflix; you know, I feel bad for the people that were involved with that. Because that's not a fun place to be, and I feel for them. But we could take a learning experience from that. And like Andrew said about Warren Buffett, we're not Warren Buffett, none of us are, and the knowledge and the experience that that man has is legendary. Not only that, but just as a brain.

So he thinks differently than we do. And so I think sometimes we have to, like Andrew said, the hubris, and we have to remind ourselves that we are not that and that we just need to be conscious of what our strengths and our weaknesses are and try to work with those because those will help you much more in the long run than investing all of your net worth in the company that you work for. And I'm gonna say you shouldn't invest in the company that you work for. You absolutely should. But unless you're the founder, you have a choice of where you want to spread out your wealth. And I think That a great way to invest is by the kind of spreading your bets around. Yeah, well said. All right, so now that we beat that pony to death let's, let's take another crack at another one here.

Hi, Andrew. Thank you for your radio show. I enjoy it. I have a question about researching dividend stocks. I subscribe to your newsletter, and that makes it a good place to start investing. See, I popped up in an article with a signal, by the way, in an article from 2019 that popped up when I researched model investment portfolios. When I looked further into it, the jump and dividend were staggering. What research do I need to do next to avoid a dividend trap? Thank you sincerely, Katie. So Andrew, the drip King? What are your thoughts? What do we need to do to avoid a dividend trap?

A

Andrew

10:43

I think the first step and the easiest step is to look at the payout ratio. So basically, what we're doing is looking at how much does the company make in profit? And then how much of that are they paying a dividend. So I think we can obviously say you don't want a company paying out more than they actually earned. They might maybe do that once or twice, but even then, that's kind of, you're starting to get into danger zone a little bit. So you want to look at that proportion, you know, make that comparison.

So that's called the dividend payout ratio. So you can take, so I like using quick fs.net, quick F s.net. Just double emphasize. So if I talk too fast, you can remember it for later; they have at the very front page of any company you look at, you go down to the bottom, and you'll see earnings per share row, and you'll see dividends per share row. And they have those that should be close to each other. And you can compare how many dividends are paid out versus how much earnings they have. So in the case of Cigna, just looking at the dividend payout ratio, their most recent dividend was $4, and their earnings per share were 15, almost $16.

So you're looking at about a 25% payout ratio; they paid about a quarter of their earnings that year in a dividend. So I think anything below 75 is generally safe. I prefer to kind of go to the ones below 50. Because those are kind of leaving more earnings to be reinvested later or do stock buybacks or make acquisitions. So the lower is better. And that would be the first place to look would be the dividend payout ratio.

D

Dave

12:25

Is there anything to do with a maybe what industry that companies might be in? Or maybe how mature the companies could be? Would that have an impact on the dividend payout ratio? Yeah, sure.

A

Andrew

12:37

So I guess more mature industries will tend to have higher dividend payout ratios because they don't have as much potential for future growth. So you actually, if that's the case, and the company you're looking at, you do want to see that because you don't want management just spending $15 billion on some fantasy they have; you would rather see some of that money actually turn either turn a profit turn into growth or just give it back to who it belongs to, which would be the shareholders.

In the case of industries. We've talked about REITs. In the past, we had a great interview with Christopher Volk, co-founder of a public REIT, several REITs, actually. And so, they are required by law to have a specific amount of payout ratio overtime outside of that. Yeah, I mean, industries are funny because everybody just copies everybody else. So you might see other companies doing payout ratios just because that's what their peers are they're doing. But in general, yeah, higher power ratio for slower-growing stocks. That's what you'll tend to see.

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Dave

13:43

Yeah, that's good information. So when we were talking about looking at this question to answer for Katie, I did a little bit of quick research on Cigna because I was kind of curious about why she was asking this question. So several things that kind of popped out that may help you when you're kind of trying to do some research to maybe understand what's driving something like this. So, for example, Cigna went from paying four cents a share in dividends annually to $4, a share for some four cents to $4. So that's a pretty big jump, I think, what is it 1,000% or something like that. So that's kind of a big that end.

So we see something like that that would make your eyes kind of bug out, like what was that? So the first thing that really I looked at was I wanted to look at the revenue of the company. So I saw the payout ratio, like Andrew was talking about; I could see that compared to the earnings, it was, you know, relatively low. So then I looked up at the top of the income statement where the revenue is, and you can see that the company has been growing revenues fairly steadily over the last five or six years, but there was something that jumped out at me and back in 2019. One of their line items on their revenue jumped quite a bit from around four or five billion to about 100 billion. So that was like, Oh, what happened here. So obviously, they made an acquisition because you don't create something out of the air and that kind of industry that all of a sudden, you know, increases your revenue by $96 billion. That's a big chunk of change. So Andrew did a little quick Google search. And it turned out that they had bought Express Scripts, which was one of the larger pharmaceutical companies. So and Cigna actually was attempted to be bought out by Aetna in 2015.

But it was rejected because of regulatory concerns. So the company has been going through some mergers and acquisition activities, trying to get bigger. Anyway.

So that acquisition led me to ask two other questions. How did they finance that? And so then I looked at the balance sheet, and I could see that they grew debt by a lot. So from about 4.1 billion to 39 billion. So that's a big jump. And then their goodwill, which is another line item under the asset section, also jumped roughly around the same amount. So I could see that the company had taken on debt. And they added some goodwill to the balance sheet, which increased their debt and our liabilities and their assets on the balance sheet. And that's how they funded buying Express Scripts. And then the last kind of, I guess, quick analysis is I looked at their cash flow statement. And I could see over the last three or four years that they've been growing cash flow for the business. And they've also been paying down the debt. And they've been increasing the dividend, as well as paying, increasing share buybacks.

So they're generating a pretty good amount of cash flow and are using that to give back to investors like Katie, if she bought Cigna, two in both the form of a dividend which they greatly increased. And they also are doing a lot of share buybacks. And also, so my last little, I guess, a tour of the kind of doing a quick analysis of the company is I looked at their latest earnings quarterly call, and I did a ctrl F for dividends. And I could see that the company was talking about raising their dividend next year by 12%, that's their target. And so that is, it's obvious this is part of their plan now is to start paying a pretty good dividend, a healthy dividend for investors. And that's one way that they'll help hopefully be able to attract more shareholders as they go along. And it's obviously part of management's plan as a way to give back to those shareholders that have invested with the company.

So those are, I guess, some quick, easy ways to kind of look through the financials without having to dive into every nitty-gritty word of the 10k or the 10. Q, to kind of give you an idea of, you know, hey, what's going on here?

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Dave

17:46

Where did this dividend come from? So, for example, let's say that the company did not make this acquisition, and they just took on a whole bunch of debt, and now they're paying out a dividend, and they're not paying that debt down, that would not be a good thing. That's not something you would want to see. Because now the company is taking on, it's kind of like, borrowing $10,000, to start having a whole bunch of parties, with your friends at home. Why would you do that? And I'm sure there are reasons. But if fiscally, that's maybe not the wisest decision to make. And so, although the party would probably be epic, it may not be the wisest financial decision. So when you see companies do that, those are not companies you want to invest in.

That's not management; you want to put your money behind because they're not doing things that are in the best interest of you, as well as the business. So these are all just little things that you can look at as you go along; you'll learn these little tricks to help you kind of do some quick analysis to figure out if this is something that could be in line with what you want to see, or maybe not so much. So I hope that helps answer your question, Katie.

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Andrew

18:49

That was a great tour. I think a lot. Appreciate that. Thanks. So let's move on to the last question for tonight. Hi, David. Andrew, thanks for the wonderful content. I have been a listener of the podcast for quite some time now, and I've truly found your work beneficial for my financial well; being that's awesome given the 10 to 12-year bull market and dominant tech stock market that we are in, I wanted to explore alternatives to hedge against a bear market and came across ticker TC s while it is a leveraged fund and is inherently more volatile. I wanted to gather your thoughts on if this is a strong hedge investment considering its extremely low price lending way too minimal downside with large upside potential. Thank you again. Okay,

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Dave

19:33

so let's talk about this interesting question. So the ticker TECS. So what is that? So this is a fund that is run by I'm probably going to butcher this Direxion. Is that how you think you would say that, or me or direction? It's spelled dir e x IO N, and it's a daily technology ETF, and they have Bear and have a Bull. And it's a three-time share. So basically, what it is, is this fund is attempting to meet a 300 positive or 300% negative return daily. And they do that by leveraging the fund by using derivatives and future options to generate returns for the fund.

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Andrew

20:27

So basically, the group of stocks that they're trying to track, they're just trying to match what those groups of stocks do. So if that group of stocks goes up to dollars, they're going to leverage it three times because it's a 3x. So they're going to try to make the fund go up to six; if the group of stocks went down to $2, they're going to try to make the fund go down to negative six. So it's not like they're making bets necessarily. They're just trying to follow a group of stocks up or down. And just trading options, and all of those fancy exotic instruments to make those returns match that their relation.

D

Dave

21:04

Yeah, that's way better than I was doing. Way better. So I looked up, I went to their website, and I saw the top 10 holdings of the fund. And here's the listing. It's Apple, Microsoft, Nvidia, Visa, MasterCard, Broadcom, Cisco, Adobe, Accenture, and Salesforce. And that makes up around 60% of the fund, with Apple and Microsoft controlling about 45% of the funds. So it's obviously heavy, and it's very heavy with Apple and Microsoft. And so by and large, I mean, those are all companies, you know, wouldn't break my heart to own just outright. So I guess I'm curious to hear what your thoughts are on kind of the idea behind this and kind of what it's trying to do.

A

Andrew

21:51

I mean, I don't like it because, number one, I don't think you want to bet against the economy, at least for the long term, right. And if we can establish that, well, if you're just trying to beat the economy over the short term, now you're getting into market timing, and I haven't met anybody who's done that successfully, consistently over a long period of time, maybe you have a magic eight ball that is very accurate, that I don't have outside of having one of those, I don't know how you time betting against the economy unless you're like Michael Burry or somebody like that. Secondly, Microsoft and Apple are two of the three companies I think that have triple-A credit ratings, which means they are considered the safest investments, like default risk, like they're not, they're very unlikely to go bankrupt.

And if I look around and I see how much I like my iPhone, how many people around me have iPhones? How many people have Windows computers and all the other great services Microsoft has? That's a tough bet. But you know, on the flip side, I do see the idea that it's been a bull market for a while; you feel like tech is expensive. So there is some logic to that part. But you start mixing leverage and then the timing aspect into it. I think there are a lot of potential issues there. Curious what you see with that,

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Dave

23:08

I kind of agree with the idea that I don't want to bet against the economy. And I don't know that I would necessarily want to bet against Microsoft, Apple and Visa, and MasterCard alone; just those four companies are fantastic bets on how well the economy is going to do going forward. And I understand the idea of wanting to kind of hedge against what you think might be a potential bear market or coming recession.

And those are certain things that are possible and could easily happen. But it's not something that I would necessarily want to bet against. And when I'm investing, I'm really looking at the future and the long-term performance of the company. And so I'm betting when I invest in visa, which I do, I'm betting that that company is going to be successful over a long period of time, regardless of what happens over the next six months or two years, I think at ten years, that company is going to be even better than it is today.

And so, I don't need to hedge against it because that's all for it. Because I think it's going to be a great company. And when you start for me, when you start putting leverage into the whole equation, that scares me because you can amplify positive and negative and that, you know, we've talked about this before, but you know, if it goes down 10% that it means it has to regain. A

Andrew

24:30

Okay. Let's say you made 80% of your money; you have $100, you make 80% of your money that's $80, you have $180. If you have that, that $100, You lose 80%. You lost $80; you're down to $20. We understand that simple math, right? The problem comes in where when you lose money, you're starting back at the square beforehand. So it's like one step forward, two steps back when you lose money. So let's take that 80%. Again, we lost 80%; we went from 100 to 20. If you made 80% on your 20, the two steps back you took, that's only, let's say you even tripled your money; you made 200%, not even 80%. If you tripled your money from $20, you're still only at 60.

So you still haven't broken even from the 100 from the ad loss before. And so let's say we went the other way, let's say we won first, and then we lost, right, maybe we took two steps forward. And then we thought we could only take one step back; if you made the ad, you're at one ad. And then if you lose 80% of one ad, you're down to like 30 bucks. So again, you have to like more than triple your money. And that's a lot more than just 80%. So you can see losses her way more than gains. And so when you add leverage, all you're doing is magnifying your losses; yes, you're magnifying your gains. But if you're magnifying your losses and your gains equally, you're gonna just it's not going to make you money over the long term. That's just the sheer numbers of it. And that's, I guess, a pretty decent reason why Buffett's kind of slow and steady wins, the race concept has worked so well because he hasn't taken 70-80 % losses, maybe like once or twice in his career. Outside of that, it's been very minimal.

So it's a very weird concept. And I didn't understand that for a long time. But once I did, I was like, Oh, wow. Like we more people need to talk about this. Because that's just the simple fact, you take one step forward and four steps back when you talk about investing. It's very, very hard to get back from that. So why would you leverage up to experience that yourself? Shouldn't you? And if you look at the track record of so many of these leveraged ETFs, they're terrible.

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Dave

26:49

We actually did talk about that. What is the track record for this particular one?

A

Andrew

26:53

I think it was over the last five years; it was like minus 99%. That's what it said; I'm gonna go finance. That's you're never coming back from that outside of hitting the lottery.

D

Dave

27:03

Right? Yeah. So I think we would probably agree that maybe this is not the best idea; I would probably argue that it would be much better to focus on trying to find the best investments you can and find good investments that are going to do well for you over a long period of time. And that's probably the better hedge than trying to get exotic; it even says on their prospectus that this is something that is only for sophisticated investors was kind of how they put it. So when they start using words like that, I think that I'm out.

A

Andrew

27:32

That's a pretty good philosophy.

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Dave

27:35

I think we will go ahead and wrap up our conversation for this evening. Wanted to thank everybody for taking the time to send us those fantastic questions. Those are awesome. And you sent us some great stuff. So these are very interesting topics for us to discuss. And hopefully, you guys are getting some good information from all of this. So without any further ado, I will 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, and we'll talk to you all next week.