IFB236: Differences Between ETFs and Mutual Funds, and Investing in Companies Beyond Their Fair Value

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Dave

0:00

All right, folks, welcome to Investing for Beginners podcast. Tonight we have episode 236. And we're going to answer three great listener questions we got recently. So without any further ado, I will go ahead and read the first question. And then Andrew and I will do our little chat between ourselves. So here we go. Hey, guys, I'm an 18-year-old from Minnesota, and I've been a listener for about two years now. I am very interested in the world of business, and I'm majoring in finance. And next year in college, I have recently started putting $150 a month into a total market index fund for my paycheck.

My dad and other people have told me that I should be investing in mutual funds. But it seems that you both advocate for investing in individual stocks more. Do you have any advice on which path I should pursue? Thanks for all you both do. So Andrew, let's unpack this a little bit. What are your thoughts on this? Great question.

Andrew

0:49

Maybe we can start breaking down? What's an index fund? What's a mutual fund just in case somebody's tuning in for the first time? So how would you define each of those and, like, super basic terms?

Dave

1:00

super basic terms. Okay, so I'll take a stab at this. So here we go. Index funds, generally, are a fund that matches a particular index, with the most common one that most people are familiar with would be the s&p 500. So anything that matches the complete s&p 500 would be an index fund. You could have them for the NASDAQ, you could have them for the Dow, you can have them for international funds, there are all kinds of mixing and matching you can do, but they're generally passive funds. They're designed to match the returns of those particular indexes. And to kind of equal those returns. And so those are generally what those are index funds also generally tend to have lower fees than others, but not necessarily the egoless. Mutual funds are actively managed funds that a fund manager puts together, and then they pick and choose the different kinds of things that they're going to mimic.

Sometimes they will mimic the s&p 500. Sometimes they'll mix and match different things. And the fees tend to be a little bit higher because it's an actively managed fund. There are other differences between the two. But I think that's kind of an overall theme, I guess, a generality of both funds.

Andrew

2:12

Yeah. So basically, groups of stocks are packaged nicely together, or the other path is picking individual stocks, which the listener mentioned that you and I both advocate for. I know for me; personally, I've never bought a mutual fund unless that was the only option I had in a 401k. To me, given a choice between a mutual fund or an index fund, I will always pick the index fund because those fees are lower. And I would rather when it comes to funds; I would rather have something that just mimics the index versus having to be actively managed. How about you?

Dave

2:51

Yeah, I would tend to agree; I think I might have had a mutual fund for a bond fund in my 401k. Before but everything else was an index fund. And I tried to stay away from mutual funds simply for the fact that the fees tended to be quite a bit higher. And there's been all kinds of studies that have shown that a lot of the mutual funds, by and large, there are obviously exceptions, but by and large, the industry underperformed the market over long periods of time.

And I think that's why people started moving away from mutual funds and more embracing ETFs and index funds, partly because they got better returns. And partly because there were lower fees and a great podcast episode we're going to release here soon, with Nick lazuli, and he talked about the impact fees can have on your returns and how crucial that really can be made. I think a 2% or 1% is a big difference. But over a long period of time, it could definitely eat into your returns that

Andrew

3:45

1% does eat up if you're talking about your life savings talking about you know, if that's 10s of 1000s, hundreds of 1000s of dollars, maybe you hit the million dollar mark, you're talking about 1000s 10s of 1000s of dollars in fees every year, that adds up that 1% on top of one per se it's snowballed just like everything else in investing. So you do have to be careful with those fees. Now, before we move on to the next question, I do want to talk about the mentioned that we both advocate for investing in individual stocks more. So I will

say I feel like I haven't really talked much about that in a while, if ever, so maybe I could use this opportunity to do that. It's something I feel really strongly about. And so, in my opinion, probably a significant portion of listeners are probably better served just buying an index fund and calling it a day. And there's no shame in buying an index fund calling in the day. Because it's simple. It's really fast and easy to do. And you don't really have to think much about it with a caveat. The problem is it's simple if you do it the right way.

So one of the pet peeves I have in this industry, in particular, is people will tell you just buy an index fund and forget about it. It's true. But that advice does not work when things start to fall apart, and they start to fall to pieces. And it's hard to continue holding firm and stay strong and hold on to those index funds, which is what you need to do when things get tough. It's hard to do that when you don't really understand what is even in an index fund. And what is that all about? So, you know, just because Richard across the street said, I should buy an index fund and hold it. That sounds great; when the markets are going up, where two years from now, when Richard move, and I don't have any way to ask about an index fund, I'm gonna freak out and sell right. So that's why I think if people want to index funds, they should, but they really need to spend the time and learn why those work out.

And through learning about everything we try to teach here, the stock market, what are the basics of the stock market, what's the basics of an index fund businesses, it's going down the street and seeing customers being served and being happy. Those are the basics behind what makes an index fund work and why it will work over the long term. To me, if you don't hear that message, I think there was research somewhere saying if you didn't hear a message takes you seven times to hear a message before you internalize a message. So all of these things that pop up when investors panic and they sell too early, or they sell because they're scared, whether it's inflation, or it's the feather, it's the economy, by the way, recessions do happen all the time, right? All of these little things that people don't think about. But that's why you need to learn about getting to the basics. And make sure you're doing that before you're investing. So that's kind of like my piece on I think a lot of people should do an index fund; probably, they should forget about it and move on. So I personally do individual stocks. And the reason why I do is that it is very inspiring.

For me, it's personal, and I'm able to tangibly see where my money is going, and when I'm able to do that, it really incentivizes me to save and invest more and more and more. So if I were to give an example, take a store, like Dick's Sporting Goods, I think most people probably should be familiar with a Dick's Sporting Goods is a bunch of sporting goods, it's cleats, you know, baseball bats, but that's the one right, they have golf Galaxy inside most of these Dick's Sporting Goods.

And so when I go inside the Dick's Sporting Goods, I can go in there, and I can see somebody leaving with a new set of golf clubs. And so I can see, oh, look, this business is making money, I can go down to the top golfer, the drive shack, these places where it's like, you have to wait hours sometimes to get a bay to be able to go play all these new golfers young millennials who are taking up the sport for the first time, I can see that and then see them going to Dick's, see them having to buy new golf clubs, new golf shoes, new golf balls, all of that stuff. And so, for me, as an investor in Dick's Sporting Goods, I can see that playing out with my own eyes. And to me, that's very tangible. And it's a way to see how my investment is kind of working. And oh, by the way, four times a year, every three months, I get a nice dividend that goes straight into my brokerage account. And that's Dick's Sporting Goods, say, hey, we sold a bunch of golf clubs, here's a portion of that back. So to me, it's like a feeling of being able to see and experience what investing really is and being able to internalize it; I found that so motivating ever since the first time I bought Microsoft, it was a similar idea. Like, I saw how much my brother, who spent so much time playing video games, how much he loved his ex-Xbox. This was back in 2012. And I knew Microsoft, oh, next Xbox. So I could. It wasn't the greatest analysis back then. But it was enough to get me in the game and get me participating in that. And so, for me, that gets me really excited. And it's more tangible in that way than the kind of just feeling like a cog in the

machine. To me, of course, I also the reason why I pick individual stocks is that I do believe I could beat the market.

Of course, there's that too. So you know, you have to have the passion there. I think otherwise; there's no point in really trying. I've found that when I look at the way we talk about stocks, Dave, it's hard to find other people who are most 99% of people probably aren't as passionate about this stuff as we are. So I think that plays a huge advantage. You're like one of my secret weapons here. I mean, we've talked a lot, and ever since I brought you into the process, it's done great things for the stocks I've been able to pick and see. So that's why I pick individual stocks. And I can see other people choosing that way as well. Whether you follow the pics, I do, or you do it yourself. But that all said, you know there's no shame in buying an index fund and being happy if you're happy with 10% a year doing that and not worrying about a lot of the other things as long as you've internalized what's really important, the principles and the fundamentals of what's going to give you a good chance to do well, in the future.

Dave

10:07

Yeah, amen. I love the idea of understanding the basics and the fundamentals before you go on and do other things. And if you watch just about any sports movie, they all those coaches that are so famous, they just pound on the fundamentals before they can start doing the fun stuff. You know, Remember the Titans, you know, they're talking about all the fundamentals throughout the book, and you know, we're going to be, you know, a strong fundamental team. And it's the same thing with investing in; it doesn't matter what you're investing in, it's still you have to understand the basic mechanics of how the stock market operates, what you're buying, what's involved in buying what you're buying.

And so you can take advantage of those things. And also, it can; as you said, it can give you some comfort when things are maybe not going as well as they have been for the last five or six months. And that's normal; it's part of the process of investing; it's not always going to go up into the right; there are going to be times where it's going to be sideways or down. And if you don't have the basics, and you don't kind of have a grasp and understand how the market works, and what it is that you're buying, and what stocks are in those index funds, or those mutual funds or the ETFs, then you're not going to understand why those things are going down. And when you don't have that basic knowledge, it can lead you to make some emotional choices. It's already challenging enough emotionally to deal with some of the roller coasters. And so I agree with you, for some reason, there's a stigma about, you know, picking individual stocks versus, you know, picking index funds, and it's all investing. And the basic foundation of all of it is the same. And it really comes down to what you're passionate about, like Andrew and I are both very passionate about individual stocks; we love learning about companies and how they operate and all the ins and outs of them. And it's fascinating, it's endlessly fascinating to me, and I know it is to Andrew and a lot of other people out there, but some people don't have that passion. And that's great, you know, each to their own.

You know, some people like this kind of music, some people like that kind of music. Same with the food, you know, it's just everybody has their own individual tastes. And there's also the fact that some people don't have the time to spend the time necessary to look at individual companies. And it's not looking at something and reading it for a minute and a half and deciding, hey, this is what I'm going to buy for the next, you know, few years. A lot of times, you know, unless you're following somebody, a lot of times, you know, there's work that needs to be done. And sometimes, you know, buying ETFs or index funds works better for people's lives. And for a lot of people, that's just a better use of time, because they got four kids, three jobs, a

wife, you know, a boyfriend, a husband, you know, significant other have some short, you know, they just have so many other things taking up their time.

They just don't have the time to devote all that. And so, you know, looking at individual stocks may not be the best use of their time for the bang for their buck kind of thing. But still, understanding the basics of what you're doing is still fundamental to that. I wholeheartedly agree with everything Andrew was saying. And so I think I'm going to stop. So because he did a great job. And you know, I have nothing else to add, so unless you'd like to tag on, why don't we go ahead and move on to the next question.

Andrew

13:21

Yeah, let's do the next one. That was good. So Hi, Andrew and Dave. I'm Jason, a 19-year-old worker student in Italy. I started listening to your podcast a while now. I opened a brokerage account and started investing monthly in the s&p 500 and dividend stocks. I find value investing really interesting. I'm diving more into it every day.

But there's a question I need to ask. Let's say I found a great company that gives dividends. I think it's undervalued; I buy it, and reinvesting it monthly after five years is still growing, and the same for the dividends. But then that stock price rises for reasons XYZ, and the intrinsic value that I give to it is far lower than the current stock price. In this situation, should I continue to dollar cost averaging and get good dividends? So maybe that first part of the question, if I understand it correctly, he's buying the stock; he thought it was undervalued. Now, are the stocks way higher than what he thinks it's valued? Should he continue dollar cost averaging into it?

Dave

14:23

That's a great question. And it can be a tough one to answer because I hate to use this term. It depends. It's such a lame phrase; it really does depend. So how about I'll take one side, and then maybe Andrew can take the other. So if I was going to say, I'd just use a company, let's say you're buying a company and it is I'll pick a How about Adobe. So Adobe is a company that I bought at the time the stock market crashed; I thought it was undervalued, I was able to get a great company, and it was paying me a dividend, and it kept going up. At some point, the company would get at a high enough valuation that I don't think that it could keep growing. But I don't know if I want to keep putting money into it.

And at that point, I would want to try to find a better use of my money and try to find a better idea that I think could grow faster. Because at some point, every company will it'll meet gravity, and so that growth should slow down doesn't always mean it will. There are always those exceptions to the rule. Amazon, until recently, Costco is a great example of a company that just keeps going up, and it just keeps defying logic. And every time you look at it, you think, why didn't I buy this, and it just keeps going up, because it's too expensive, but it keeps going up, you know, it's just one of those things.

But let's say that our example Adobe keeps going up. For me, I will start to look for something that maybe offers me a better return over a longer period of time because maybe that's more undervalued. And if you keep adding to that position, Adobe, as it keeps going up, you're going to reduce your you're going to

increase your cost basis, which means in time, your return might slow down. And that would that could harm you. Now, I guess I'm going to be curious to hear what Andrew has to say, maybe on a different tact of that.

Andrew

16:11

So one of the quotes I've heard from the great Peter Lynch, Peter Lynch, was this all-star investor for fidelity. And he said, selling your low on a butcher, I know what you're gonna say, selling your winners and buying your losers is like watering the weeds and cutting the flowers, something like that. And so it's this kind of like this idea that the stocks that are going up are probably going up for a good reason, probably because the company's doing a great job. At the same time, the stocks that are going down might be going down because the business is actually really struggling. So you can always look at the two sides, just like Dave was saying, where I've added two winners and then saw the price came down. And I was like,

Oh, I was trying to water the flowers; flower turned into we've also added and then ended up being a great time to add even though the price had gone up a lot. Because the company continued to grow, continue to grow. So you really, I think, have to look at the company itself, how that reflects in your whole investing plan. I mean, I'm sure people probably do it differently. I always try to find a new stock every month. So I can get diversification through the next 12-month period that I might have. Sometimes I might break that rule. But in general, I tried to do that. But for somebody else, maybe they're doing that a lot less frequently. So you really just have to balance between what's your personal dollar cost averaging strategy? And then what are the opportunities that are right in front of you right now. I think that's what makes investing so interesting. Because Apple stock, for example, was a great time to buy it when Buffett bought it. But if you bought it when it was super, super expensive, it might not be a great time to buy it. So we're looking at the same stock in two different time periods; you really just have to take what opportunities are in front of you.

That's why I think you have to look at why did the stock price rise? What are my other opportunities? And how am I gonna make that decision? So to me, I can't really say, Well, yes, you should dollar cost average or yes, you should.

Dave

18:18

Yeah, I would agree with that. And the thing about value investing is there are so many different shades of it. And there are some people in the value investing world that will buy something that's undervalued, and then they will hold it till it becomes what they think is very valued. They'll sell that, take those proceeds and use it to buy something else, kind of rinse and repeat, rinse and repeat. And just keep doing that. And there are a lot of people in the value investing world that do that; they swear by it, and it works great for them; I guess I fall into the camp of the Peter Lynch idea of trying to keep watering my flowers and cutting the weeds kind of idea. It can make it a bit more challenging.

But Charlie Munger also said something great, he said, never interrupt compounding, you'll never stop compounding and unnecessarily, that's one of the great tragedies of investing is sometimes getting out, you know, before the train gets used a roll down the road. And I think that's one of the things that he and Warren Buffett have done an amazing job with is their mindset of being able to stick with a company like American Express or a Visa or any of these other companies that they've owned for, you know, Coca Cola for, you know, multiple, multiple, multiple decades, and it just keeps rolling down the track. And a lot of other people would have sold out a long time ago, but they would have lost all that compounding that they've gained. And

so that's part of the metal part that can make it a big challenge. But I prefer to follow Peter Lynch's idea. I think it works better for me personally. And so I think it just really kind of comes down to what you're comfortable with.

And if you're not comfortable holding after you think the company has a fair value, then follow that path. You want to keep trying to what are the roses then, you know, by all means, you know, think about that as well. So I hope that helps answer Jason's question. All right, well, we will go ahead and move on to the next question. So we have Hello; I have been listening to your podcast for a few weeks. And I've learned a lot. Just subscribed to your E letter yesterday. I would like to follow along with your investing strategy. I have just gotten interested in buying stocks, and I'm trying to play catch up with my retirement portfolio. I am 50 years old and was wondering if I could significantly benefit from following your model for 10 to 15 years. My other question is, do you recommend just starting the purchase of recommended stocks going forward? Or should I be looking at purchasing the ones currently in your portfolio, your guidance would be much appreciated. Thanks, Angie. So, Andrew, this is right up your alley. So what are your thoughts on Angie's Great question?

Andrew

20:44

That's a great question about the time horizon for me, and I just wrote a blog post about this recently. So it's pretty timely; I like to look at trying to hold stocks for 10 to 20 years. That's a good goal to shoot for. We've had several guests on who have talked about why that's the case; you can take the history of the stock market, which spans many, many decades; by the way, you can look at 10, year five, year 15, year 20-year time periods. And as you expand that time horizon, the better your results have been if you bought in the stock market, regardless of how much you pay. And so especially that 10, year, 15 years 20-year time horizon, that has a pretty good chance that each thing you buy being profitable. When I look at a stock, I look; obviously, nobody can look into the future. But I try to see, at least for the next ten years, can I reasonably estimate what kind of profitability I think this company is going to have. You can never do that perfectly, which is why you buy multiple socks.

That's why you diversify. But over the next ten years, what are the things that make me think the company can grow this much, can get this much more profitable, and see that reflected in the stock price over the long term. So the longer you hold the stock in general, the more of a chance that the market will catch up with what the business is doing. Because the markets are very emotional like we've taught before, Mr. Markets, a manic depressive monster, and things will go in and other fashion, things go in and out of trend. And investors run away or run to lots of ideas really quickly. So that can make the stock market hard.

But if you look over longer time periods, 510 15 years, the stock market starts to reflect more on what's going on with the businesses. So that's why I look at what the business is doing now; what is it done? What does it look like it can do in the future? And that factors into why we buy a stock and why we hold the stock. So I would say a 10 to 15-year time horizon, I think, is right in that sweet spot, though I would probably recommend if it was me personally, I would look into like bonds to like, just to have that into my mindset. When do I want to start putting into bonds for retirement for the next 10 to 15 years, though? Yeah, stocks look great as far as when subscribers enter the leather. So I have my monthly newsletter; I'm making a stock pic every month; I always recommend just buying whatever we are buying that same month.

And it goes for that exact reason. I said in the last answer we could be looking at Apple stock; it could have been a great time to buy it; when Buffett bought it, maybe you bought at the top, and those too expensive that might not have been such a great time. Again, it all depends; every opportunity is different every month.

And so in my mind, I tried to do this blend of like, I want to buy a great company, I want to hold it for a very long time. But I also don't want to pay a ridiculously high price for it because that could take years off of my compounding. So that's why I'm doing that; you really have to pick your spots, be patient, and just take what the markets are giving you, something you like to tell me all the time. And I constantly need this reminder like sometimes you just got a fish where the fish are, right? Like I always like want to model my portfolio a certain way. But then you're like; I'll tell you like, Man, I want to go for the stock. But it feels like I've been buying a lot of these kinds of companies; you gotta go where the fish are. So you just have to take those opportunities where they are. And so when you subscribe to a service like the leather, there's a bunch of positions in there already. They may not be great purchases anymore. That's why you have to take each situation as it appears. That's why if it was me, I would be looking just to add each one over time as it came in.

Dave

24:41

Yeah, that's the perfect way to do it because it will allow you to build a portfolio over a period of time. And he also in the letter will tell you about different companies from time to time that is offering an opportunity now. So even though it's been something that he bought in the past, it's a good value to buy now as well. And I guess the other thing to think about too is, you know, he spends a lot of time working on this. So we were talking off the air before; how many hours do you think you spend on a pic a month, at least? I'd say that's an understatement, Ali. Yeah, that's all the time, the reading of the financials, trying to find companies that are opportunities, as well, as you know, he and I talk about this a lot.

And you know, he's reading books, he's listening to the transcript, earnings calls, he's watching videos, and all these things go into it all compounds. And so companies he may have picked six months ago, the learnings he learned from that company apply to today; it's all part of the process of learning how to do all this. And that's why he does this. And that's why he spends all the time writing it out, too. It's not the write-ups are not just a, you know, a couple of words, you know, hey, buy this stock. These are all the reasons why. And all the logic behind it and everything. So there's a lot of effort and a lot of work that goes into, you know, just pick one company. And then again, that kind of goes back to the earlier conversation we have about the time spent to do something like this, you know, it's not, you know, if you want to pick individual stocks, you know, doing something with Andrew, falling his picks on the USA is a great way to do it, because he's doing all that work for you.

So he's making all the time and effort spent. And I can attest to all the hours spent because I'm not there doing it with him. But we're certainly talking about it, texting each other, going back and forth on different ideas or whatnot. And there's been a lot of companies where he's talked to me about different things, and I've kind of tried to poopoo it as much as I could, because like he said, You know, sometimes you really want to buy something because you really liked the company, or you really want to go in this direction. But sometimes you do have to fish where the fish are. And these things are all things that can help you, especially if you're nervous and you're dipping your toes into the water for the first time. You know, these are things that you can lean on to help you get over those, that anxiety and those fears. So I would definitely check it out. It's definitely worth your time and effort. Your ranking case, you guys are wondering, that's a little joke from the Warren Buffett and Charlie Munger show from their shareholder meetings. Whenever Warren gives a really long answer, Charlie, always, a lot of times, in the end, will say I have nothing else to add. And then he moves on. So it's just it's a little funny. Little funny. All right. Well, without any further ado, I will go ahead and sign us off. So again, thank you, guys, for sending out some great questions.

We really enjoy talking about this stuff. If you have any questions about anything that we talked about, you can either reach out to us or you can check out our website, einvestingforbeginners.com; we have a great resource there. There's a search bar at the top of the page that follows you wherever you go on the page. So if you have questions, if you're looking to find out more about dividends, dollar cost averaging, any of those kinds of things, mutual funds, index funds, we have all kinds of resources to help you learn more about all these things, as well as the fundamentals. If you're new to podcasting, if you're new to investing, go check out our investing for beginners series. It's episodes 43 through 47, I believe

Andrew

28:06

in okay. It's not 43. It's either 42 or 43. You're probably

Dave

28:12

good our podcast page on our website. It does tell you all the beginner episodes there and walks you through all the beginning episodes is a great resource for you to kind of get your feet wet and learn. So without 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. We'll talk to you all next week.

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