IFB243: What You Can Buy on the Dip

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Dave

0:00

All right, folks, welcome to Investing for Beginners Podcast. Today we have episode 243. And tonight, Andrew and I thought we would talk a little bit about what you can buy for the dip. We recently did an episode where we talked about maybe what you shouldn't buy during a dip. Now we're going to talk about what you should buy or could buy. Maybe that's a better way of putting it during the dip.

So Andrew and I kind of came up with some different categories. And we thought we would give you an overview of some of these different categories. So without that, any further ado, let's go ahead and dive in. Andrew, do you want to give me your first category, if you will?

Andrew

0:39

Sure. Let's think of these as like mental models. I'm not gonna give any particular names because people pay me money, $29 a month for those, but I will give some mental models. So the first one will be not as controversial. The second one will be controversial. And the third one is a surprise that one's special. Little secret sauce. So the first one, it's pretty simple Garp growth at a reasonable price. And so what do you want to look for here are companies that have always traded above average valuations. So, you know, they might be, if you had an industry and you had like four players in the industry, maybe they're the number two or the number one.

And so they always trade at a higher price to earnings ratio than their competitors. And so as they've come down, it might be a good time to buy a stock like that. Because now the price earnings, maybe it's not lower than the market, but maybe it's the same as the market. And that would be a great value, because you're getting an above average business at an average market price. And I would take that all day long.

Dave

1:48

I would agree with that. And that is also my first category. So we thought we would start maybe with an easy one, and then we'll kind of ease into it. So when you're looking at those kinds of companies, maybe what are some characteristics of those businesses, that would lead you to want to investigate them further, or we would consider investing in them.

Andrew

2:09

Shout out to bird's eye view Mercedes Benz episode, because it's so long ago, return on invested capital, a company that has a better return on invested capital and its peers, there has been research that shows that those companies get a valuation premium compared to their peers. So that'd be one example of a

Dave

2:31

revenue growth, you want to see top line growth for those companies, our good friend, Braden Dennis, from stratosphere, was talking about, I think it was 10% was kind of his hurdle rate, anything below that he was maybe not necessarily a hard pass, but would maybe have a little more research. So what are your thoughts on the revenue growth part of it?

Andrew

2:51

Oh, yeah, like, I would not want to buy a stock that's not growing its revenue, that can cause all sorts of problems, not just the fact that it's obviously it snowballs into all sorts of problems, you know, people don't want to work there anymore, because it's a shrinking business. And so all the talent leaves, and then it just cascades.

And stay away from that, the other thing I would kind of recommend would be either earnings per share, which is a pretty easy one for people to know if you're a beginner, if that's an above average earnings per share growth, or my preferred free cash flow per share growth. And so that you can see that with companies who are growing their revenues really well, or maybe they're really optimizing their costs, or they're buying back a lot of stock, which pushes those growth metrics up. So it's a good time to pounce on some of those companies that are better doing that than others. Yeah, it is

Dave

3:41

exactly. And I think when you're thinking about those kinds of companies, you also, it's not just about what the company is doing now, but it's also what the company can do 510 years from now. And so some of the characteristics you want to see are companies that have strong moats, or have strong products, there was a lot of demand for their product. So think about the different businesses out there that you come across in your daily life, that there's a lot of demand for those products, maybe yourself is somebody that you're I really want to have this, or this is something I can't live without.

And so finding companies that have those characteristics will naturally lead to revenue growth, and good revenue growth. And it's not saying that you got to go out and find the, you know, the company is growing at 40% a year for the next 10 years. Because those are unicorns, but you do want to find companies that are going to continue to grow because for it to be considered a growth at a reasonable price. People aren't going to invest pay up for companies that aren't growing. And so that's one of the kind of the requirements is you want to see a company that is growing those revenues. That's a good point. All right, so let's move on to your second category,

Andrew

4:50

if you will. Okay, this one might get some people who are they're gonna get like an adverse reaction like, oh, but in reality, you're wrong. So cyclicals nobody wants to buy cyclicals when the market is down. And it makes sense because there's a recession coming up. And the definition of a cyclical company is that when there's a recession, it doesn't do well. And so obviously the stock price has come down. Now maybe you don't want to buy a cyclical right before the market crashes.

But as the market crashes, that's a great time to buy a cyclical on the dip. Because guess what, if I'm buying a cyclical and it drops another 50%, from here, I'm talking about the stock price, not financials, just the stock price, I don't care, because if it triples in the next two years, that our initial 50%, that dropped doesn't affect me one bit. This is a very specific advice for cyclical companies, because they will have these kinds of huge swings because they are cyclicals. So you wouldn't see this in like a best of breed kind of business or a growth of a reasonable price kind of business, you probably won't see that if one of those businesses are dropping a lot, it's probably for a good reason, because their product or service or moat has eroded.

And the recession has kind of expose that for a cyclical they could just drop because they're cyclical and they could drop huge, but they also bounce up huge. And so these are things that are tied with like discretionary spending, where it might be a really great product. But if you're tightening the belt, you don't necessarily go out and buy it. And so when you buy the cyclicals, you don't want to just buy any cyclical and you certainly don't want to buy the cheapest one, that would be probably a good way to get burned over and over again, what you do want to do is you want to find the ones that have a significant competitive advantage over their peers. And I think you're gonna get a lot of similar themes with all these stocks that you buy on the dip, but one that's better than its peers, or just has like an incredible niche that is unbreakable. Maybe it's a small fish, but it has a very narrow lane and nobody can come in and take that.

And so you really again, won't be able to buy those kinds of better businesses until there's a cyclical downturn. And so you got to take advantage. And that's very hard. Because like I said, they'll tend to be crashing harder than the rest of the market. And people will think you're an idiot for buying them. Because why would anybody buy discretionary because we're going into recession, anybody to brain cells can see that, that's what you're gonna have to do if you want to get a good cyclical at a good price. And so I think it's a great time to take advantage.

Dave

7:25

So if you were I guess let's back up for just a second, what exactly is a cyclical? So when you use that term, what are you referring to? Is that a particular type of industry or industries? Or is it more talking about the, I guess, the cycle of the business? Yeah, that's

Andrew

7:43

kind of the way they generate their profits. So when the economy is booming, they'll have probably more profits than the average company. But then the flip side of that is when the economy goes into recession, they probably fall into harder times. And I guess what makes it hard is there's degrees of cyclicality. And some industries are super, super boom and bust. I know I promised someone say any companies. So I'm not gonna say companies.

But I don't have any investments in the steel industry. Right now. Most of that industry is very boom and bust at least the ones that have to build plants, semiconductors, similar thing, but you know, it is relative to because you could have a distributor in a super cyclical industry, that's not as cyclical, but the ones that actually have to make the capital outlays, the ones that are investing capital and these things projects take 357 10 years, those can be very, very cyclical, because of the long timeframe of investing in capital and projects and how uncertain that is. That's why you'll see the booms and busts because nobody knows.

Dave

8:43

That's a good answer. Thank you. Would commodities be considered cyclical? Yeah, most of them are. So so things like oil, or gold, copper, you know, lithium, any of those kinds of things? Those would definitely be cyclical.

Andrew

8:56

Yeah, I guess gold maybe is a little counter cyclical, because some people use it more as an investment hedge than like, actually use it in the economy. I don't know. It'd be interesting to see though, because as more of the economy goes intangible, or commodities, less boom bust than they used to be because the technology economy could be booming. Maybe the commodity market isn't? I don't know, in general, though, to answer your question. Yeah. Most of them would be cyclical.

Dave

9:23

Right. Well, that helps. All right. Well, let's move on to the third one for you. And second one for me, which is going to be kind of similar. Why don't you do yours?

Andrew

9:32

Okay. All right. So

Dave

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let's talk about value with a catalyst. So these are companies that are being beaten down for whatever reason, and they have a reason to rebound. So if you think about companies that are really strong businesses, but maybe they've had a downturn because of recent financial performance, or it could even be something that's going on in the markets. Or there could be a myriad of reasons why the company has fallen. But there is something that out there on the horizon, either a new product or a new service, or maybe they've gotten a new CEO, something along the lines, that's going to cause the company to perform better during the dip.

And those kinds of companies are some of the ones that I think Buffett really kind of gravitates towards. Especially, he's always looking for companies that like he likes to sell, he likes to buy his socks on sale, just like stocks. And for whatever reason, the market may be punishing a company because it's in an unloved sector. And even though the company may be performing really well, the stock market is leading it down. And I'm not going to give you any names, but think about the banking industry during the great financial crisis. And the time period following that a lot of those banks were beaten down for a reason. But over time, they have rebounded, they've changed their business model, they've changed how they fund loans and structure, how they look at reserves, so that they make sure that they don't ever get into that same situation again. And a lot of these companies have done really, really well over the last four or five years.

But because it's been in an air, quote, unloved sector, there has been an opportunity to buy those periodically through the years. And so those are kinds of companies that when you see them in a sector, for an industry that is being punished, maybe because there's one bad actor, but then the market just takes all of them down just because and a lot of times Mr. Market is not always logical. And so there are going to be times where you're going to see companies that are beaten down unnecessarily. And there was a situation recently, where a company announced that they saw the signs of a coming recession. And because they were announcing what everybody in their brother already knew that this is something that's been on the horizon for a while, and everybody's been asking the question, whether we are aren't are what's coming or not.

And they have a good insight into what's going on the market spanked them unmercifully, like 30% Down in the day. And this is a strong company with strong financials, and a lot going for it, and it's not going anywhere. And so why did this company get hammered so hard, it made no logical sense to me. And so that would have been an opportunity. If I knew more about the company and I was in a position to invest in that company, that would have been a great opportunity to take advantage of that at that time. And so sometimes when you're looking at investments is looking at a dislocation in the logic cavity of why this company is trading lower than it is. And it's a value play, it's an opportunity to buy something that is being depressed.

And Warren Buffett has done this several times. And that has, you know, some of them have been some of his greatest investments, because he, he took advantage of an opportunity, when he saw a great business that was selling at a discount. And so that's something that I would try to take advantage of during dips.

Andrew

13:07

Oh, for sure. I mean, that's probably the biggest opportunity set out of these three, arguably. And I like the way you described it. And I hope people pay close attention to that, I think a way another way to describe it is reversion to the mean. And it's this idea that industries go through cycles, just like the economy goes through cycles. So banking was a good example of they used to be so over leveraged. And then they went on the complete other side of being like, so over conservative that the returns on equity weren't great. And so you'll see a lot of industries, the longer you learn about the business, world and history of business and live through businesses and industries, the more you'll see that last decades, industry might be this decades graveyard for stocks, and vice versa. And there's a lot of factors that go into it. There's regulation, there's supply and demand, there's disruption, things change.

So there's a lot of opportunity and doing that, because when you buy value, obviously, your downside usually isn't that bad, because you're already paying a good price for today's cash flows. But then when you have that catalyst of something, an industry fundamentally changing and investors not recognizing it yet, then not only do you get the extra growth that you didn't pay for, but now the market recognizes that extra growth, and that will like literally multiply your results. So it doesn't happen very often. And that's why a dip can be a great time for it.

Because if you can get ahead of some of these big fundamental secular changes, you can make huge returns. And I think Buffett again, is a good example of making really, really big returns and I kind of just wanted to leave it at that unless you had something there or did you have another one?

Dave

14:53

Oh, no, I do have one other Oh, one other grouping if you will. Okay,

Andrew

14:58

my bad. Okay. Then I'll let you close with that. But I would just say that value with a catalyst is a good way to go. But can also be dangerous because you don't want to buy value with no catalyst or value that's become deeper value, because to quote buffets, when the tide goes out is when you see who's not wearing pants. And so market disruptions and recessions and tough economic times, that's when the weakest businesses will get flushed out.

And so if you're out there, value fishing for a stock that just looks so stupidly priced is probably too good to be true. So those are the type of value that I would absolutely stay away from, because there's a reason that they're cheap. And this is probably the worst time to buy that.

Dave

15:43

Absolutely. That's very well said. All right. So I guess my last grouping, if you will, is looking for world class companies at bargain prices. And so I think the way that you can think about this is Andrew mentioned, when the tide goes out, when the market goes down, everything goes down. And when the market goes up, it also raises a lot of boats that maybe not, don't necessarily need to be raised.

And so there's kind of a dichotomy this, but the flip side of that is, when the market falls a lot, you'll get opportunities to buy really, really good companies, world class companies at great prices. And would you think about these different businesses, and you know, all of us can probably list off the top of our head, you know, five, or 10 companies, which we think are some of the best in the world. And a lot of them have kind of the same characteristics. They have strong moats, they have very strong business models slash products or services, they generate lots of revenues, they have great returns on invested capital, they may or may not pay a dividend, that most of them, we'll probably buy back shares.

They have very, very strong balance sheets, which means that they have lots of cash. And they have lots of liquidity. And they have very manageable levels of debt or low debt or no debt. And so that allows them to weather the storm, if you will. And they also have great leadership drawn CEOs, or very well regarded CEOs and management teams that work with them to, you know, continually make sure that the business is is operating well. And a lot of times, what you'll see is when there's these downturns, you may see these dislocation in the price of the company versus what is actually going on with the business, the rest of the market is getting spanked. And so just by association, this company is also being drawn down as well.

But when you look at the underlying fundamentals of the business, is still kicking butt. And so that gives you an opportunity to take advantage of that. And it may not be a lot of companies, and it may not be an opportunity to buy everything you want. But you are going to get an opportunity to swing at a great company or two or five, that you can decide what you want to do at that time. And these are businesses that are going to be strong investments over a five or 10 year period. And generally they're going to be larger businesses, larger market caps, larger revenues basis, I'm not talking about companies that have a market cap of half a billion dollars, like these small micro cap companies that may go on to be fantastic businesses some day,

I'm talking about the best of breed the companies that just roll off your tongue when you think about, you know, hey, this is a fantastic business. If I ever had an opportunity to buy this, I would absolutely jump at it. And for me, that's what I'm thinking about is whenever I see a market downturn, I'm like, is this going to be the chance, you know, is this going to be the time that I can actually dive in and take advantage of this? You know, this could be the time and so those are kinds of businesses that I would look for as well preach and preach and preach own.

All right, well, with that, we will go ahead and wrap up our conversation for today. Hope you guys enjoyed our diatribes on the different types of businesses that you could buy during a dip. And think about this as a mental model that I guess a mixture of mental models that you could use to help you think through different businesses that you could take advantage of. We specifically chose not to use names, because we don't want to lead you down that path of you know, Hey, pick this one, Hey, pick this one. It's better to think about how you can use these models to find things that are going to work for you.

So without any further ado, we'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, and we'll talk to you all next week.

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