IFB244: How to Deal with a Few Companies Taking a Sizable Portion of Your Portfolio, Plus Index Funds & Trust Funds

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Dave

0:00

Alright folks, welcome to Investing for Beginners podcast tonight we have episode 244. We have four great listener questions we're gonna answer tonight. So I will go ahead and get started. So here we go. I have Hi guys, Jason here. Just wanted to thank you for the awesome information you give on the podcast Keep it coming. I'm looking at doing DCA for index funds as another investment vehicle for retirement. I have a current brokerage account for my financial advisor, but they charge about 30 bucks a trade. So I was going to open an account with Charles Schwab to avoid fees for context.

I'm 34 and looking to retire on 6570. I'm thinking of $40 a month towards the Vanguard s&p ETF fund I believe it's V O as the ticker symbol. Is there a better fund since I'm looking at long time horizon? I know I'm looking for a low expense ratio, but what else should I be looking at? I know tax implications are different from mutual funds versus ETFs. But so are expenses. I understand you can't give direct yea or nay on a fund or stock. But I'm looking for a few options that have your thoughts on and I could go deeper on my own view. Thanks. So Andrew, what are your thoughts on Jason's really excellent question.

Andrew

1:08

Yeah, well, welcome to the investing world. Jason, hopefully, it's a lot of information at once. But hopefully it's not too overwhelming, I would say your mind is in the right spot. And when it comes to buying a good index fund and DCA or dollar cost averaging into it, you really can't go wrong with either ticker symbol vo like you mentioned, or there's another one called ticker SP y, also an s&p 500 ETF on. And I believe there's one more ticker VTi. So you could really do any of those.

And they've really gotten to the point nowadays, where their fees and expenses are so competitive, that it really doesn't make much of a difference. I mean, back when they first started to make these index funds and ETFs, we were talking about huge differences between an advisor who used to charge 1%. And now these index funds which charge fractions of a percent. So it's done great things for the industry. But once you really get to the ETF, s&p 500 funds you have available today, picking between one or the other is really not worth your time, they're gonna give you all about the same thing.

Dave

2:22

Yeah, exactly. I think the interesting thing about them is because there's so many choices, it can get a little overwhelming, and a little confusing, but I think the three that Andrew mentioned, are all great choices. And they're available pretty much anywhere. And I believe you can even buy them directly through Vanguard. So you could even open an account with Vanguard, and do the trades through Vanguard and have them manage the account for you. So you wouldn't even have to do it through Schwab if you didn't want to. And I believe they would charge at the same transaction fees. So it would provide you the same option, I don't think you're gonna go wrong. Any way that you do it, I think you're in the right place, and you're in the right frame of mind.

And getting started and be consistent in establishing that habit now is going to do good things in the long run. So I applaud you, Jason for reaching out and asking this great question. So I hope that helps answer your question. So with that, let's move on to the next one. So I am a 27 year old who is about two years into light investing with a portfolio of over $1,500. Thus far, in investments to learn for myself, I am married and my wife comes from a family who has a trust fund on her mom's side, their trust fund is ran through a broker that supposedly been in the family for many years, my wife and I's life savings is under an investment account through this broker. And as split our life savings account into two different mutual funds.

Personally, I feel this broker is robbing us blind with his lack of effort into putting our money in these funds that are air quote, private and exclusive to anyone not investing through either him or his company, by receiving a percentage of what we earn through those dividends and fee for managing our portfolio. My

wife has a strong financial background in accounting. And I think we could do better. How can I convince her? Or what questions are good to ask this broker to do more work than putting in in mutual funds? All right, so this is a great question. And I know we talked a little bit about this off air. So I'm gonna let you take the first stab at answering this.

Andrew

4:17

It's interesting, because I think the easy answer is to say, oh, yeah, an advisor is screwing you over. And they're not doing anything for their fee. And so I should just do it myself. And, you know, that's certainly been the case for a lot of people as they found out over the last 1020 years. But when you start talking about a trust fund, and just some of the implications behind more complex investment choices, so for example, for a trust fund, where we're talking on the show, Dave and I, a lot of times we're coming from the perspective of somebody who's just starting, and they're building a portfolio so they're Building for growth over the long term, 1020 3040 years, when you started talking about trust funds, where there might be significant capital already in there. And then you have the complexity of a trust fund for that multiple people involved.

So one person might want this out of the trust fund, while another person might want that out of their trust fund. And so you might have people withdrawing at different rates. So they might not all be wanting to build a portfolio, like we kind of talked to a lot of people on this show. So there could be different goals, and then you have family dynamics, and then the strategies behind how you're trying to achieve your goals are going to change depending on what you're trying to do with the money. And so I think it's tough, because if there's a trust fund, we don't know anything about what that entails on the other side. But there could be a lot of complexity to it.

And by the way, just because an investment is private, or exclusive, doesn't mean they're robbing you blind. There are investment opportunities other available for people with more money that's just not available for average investors like us, as an example, private equity. Private equity is like Dunkin Donuts is a good example of a company used to be public, you could use us to be able to buy their shares on the stock market, they got taken over by a group, a private equity group. And so they don't have to do, I don't know if I'm describing this good. But they don't have the same limitations as a stock market investment does and that they basically get to choose who they invest with, instead of just being able to invest with the whole public. So that is something that advisor can help you do. I would always push for more transparency and figuring out what exactly they're investing in. But just based on what I'm reading off of this question, I

wouldn't necessarily agree to the idea that yeah, I should be running this myself. If there's other factors involved.

Dave

6:53

I would agree with that. And I think the thing you always have to keep in mind is, what are the options that the advisor has to generate the returns that you're hoping for, and also, you know, what is their background, how much you're not going to know exactly how much time they're putting in, and the different investments that they may come across, like Andrew said, the more money that you have, you will have options for other opportunities that us mere mortals may not have access to. And you know, the private equity is one, there are also different kinds of funds that you can get access to, you can also get access to bond portfolios that, you know, we mortals would not be able to access as well.

So there are going to be other options that they may have available, I think maybe, instead of being super frustrated about the situation, I would probably encourage you to reach out to the person and try to have a meeting or two or three, and see what kind of transparency you can get from that person to see what kinds of things they're doing. You know, if you are a member of the family, and you are a member of the trust, that you have the right to know what's going on with those accounts, whether that means that they provide you with financial statements, so you can see what's actually happening, or whether you're sitting down and having a conversation to learn what it is that they're doing.

But I guess always remember that there are many, many, many, many different ways to get to where you want to go. And just because you have a particular idea in mind, it may not always gel with the other people. And that's I guess, one of the challenges when you're working with a team of people, whether it's your wife, and you or your significant other and you are whether it's six or seven other family members that are in a trust, it's not going to be only your decision to make on how things go a certain way, you're going to have to work with those people to get their buy in. Because depending on what the trust is, and how it's set up, different people will have different responsibilities or ownership, if you will. And so they'll have different levels of I guess, access, as well as decision making abilities, you'll have to figure all those things out. But they're all great questions to ask. But I think the first thing I would do is sit down with a broker and figure out exactly what it is they're doing, talk to them about their plan.

And what they're playing is it gives you know that those few pieces of information, you can start to figure out a better idea of what it is they're actually doing or not. And I always like to give people the benefit of the doubt until they give me a reason not to give them the benefit of the doubt. And so I think it's an easier way

to approach people instead of coming at them from like, You're screwing me. And I want you out, maybe come at it from a perspective of Hey, show me what you're doing and how you're doing it. And they'll be probably very happy to teach you. And then if you decide that it's not the right way, then you can talk to the family and say hey, this is what he's doing. This is what he's costing us. We're not getting where we want to go. I think there's better options but it would also be who viewed and maybe have the options in place before you have the conversation with the family so that you can actually show them proof that hey, these are the things So we could do, that would be a better a better option for what is going on there.

Let's say that the broker just for example, is throwing all the money into crypto, and that you're not comfortable with that because of the speculative nature of it. And I'm not saying don't invest in crypto, so don't come at me about that. But what I am saying is, if he is doing it, and you're not comfortable with that, then that's something you definitely need to have a conversation with. So I guess I would just start with the conversation, and ask them what they're doing and how they're doing it, and then kind of go from

Andrew

10:26

there. I think that's fantastic advice. And I especially like the idea of approaching it with an open mind and more of a curious nature, rather than being accusatory, you know, the listener did mentioned, being about two years into light investing. There's a big difference between investing kind of casually on the side, and being a professional who does this all day long. And he did mention that their life savings is split into two different mutual funds.

And I know we've railed about mutual funds in the past, but depending on how he structured the mutual funds, maybe that's the way that he's getting the diversification based on the type of risk tolerance he thinks you guys should have. So again, I will go back to what Dave said, of really trying to figure out what's going on, and looking at these people as your allies and not your enemies. Because it's sometimes tough to have a investing and finance podcast, when there's 1,000,001 ways to manage a portfolio to achieve good risk adjusted returns, lower your risk, diversify all those things. The end of the day, you do have to do what you're comfortable with. And obviously you don't want to get robbed. I think the more you can learn the better decisions you'll probably make. Oh,

Dave

11:34

I agree. That's great. Great advice. All right. Let's move on to the next question. So we have Hi, Dave and Andrew. Thanks for creating such a great podcast. I'm currently invested in 28 stocks in my brokerage

account, I have between 175 and 5100. In stocks for each company. Even right now with the market not so hot. I've got about 300% in gains since I initially invested. Right now three of my stocks represent a total of 75% of my portfolio. I remember reading that a singular stock shouldn't exceed 10% of my overall portfolio.

But I'm not sure what I'm supposed to do about this. I don't want to sell shares of these three stocks, because they're all on track to continue doing well, to my knowledge, Tesla, Nvidia and apple. I can't really afford to add more to my other positions at this time, sadly, do you think I should do a deep dive into the other 25 and perhaps sell some to add to some of the other promising positions or just leave it alone and see what happens? For reference? I'm 33 and not planning to retire anytime soon. Thanks so much. You guys are the best Rachel. So Andrew, this is gonna be a fun question. What are your thoughts on Rachel's? Excellent question.

Andrew

12:41

Yeah, I love it. There's so many, so many ways we could do it. And so I'm just maybe going to vomit out a couple ideas and maybe bounce back and forth. Because there's a lot to unpack here. And this could be fun. I have no qualms of saying, Look, I'm a long term shareholder of Apple, I think I've made that public before and subscribers know about that. So I'm obviously bullish on Apple. Tesla. I was wrong about Tesla, talking them down for years on the show, they've turned it around in the sense that they've become profitable. And they're still growing like crazy.

And they somehow managed to skirt bankruptcy and survive and do crazy. Well, I love the company. And Nvidia has super great growth drivers. I mean, the future is computing, artificial intelligence, all of the things that data centers enable and invidious sits at the center of it. The problem is, yes, I think having three stocks as 75% of a portfolio is a bad idea. And I don't care if Apple is one of them. I think it's a bad idea for most investors, there's so many reasons why we could go down. But I would just say, maybe the start is businesses change a lot. And if you think of a company like Nvidia, their main product, the GPU Graphics Processing Unit, which is now using all the data centers, that was not even really a hot thing 10 years ago.

So they basically came through and they destroyed a lot of other types of chip makers because of their new innovative technology. So if they were able to do that in 10 years, ask yourself, well, what's going to happen in 10 years later, isn't Vidya going to be still the best technology? Or is it going to be something else? So I think just based alone on that, so you really want to put whether it's 25 30% of your portfolio into a single stock. That is in such a fast moving industry that you know, it really you can have serious losses. And to give one example, I feel like we use this one a lot, but it's a really good one is you had Cisco back in 1999

2000. They were the hardware stock the technology hardware stock to own during the.com Boom because the internet was just starting to take off. So the internet we all know about the inner Then how crazy that's been Cisco was the infrastructure of the internet, and everybody was buying their routers and all of their networking equipment. The problem is that stock got way too expensive. And then it crashed.

And I believe it's still hasn't recovered from that. And so at a time where the s&p 500, the market has recovered and done very well, since 1999 2000, Cisco has lost money. And if you have that happened to your portfolio, and it makes up 25 30% of your portfolio, you're gonna lose to the market. Even if you're like Warren Buffett, it's just the way the numbers work out. So you really, really have to be careful about putting such a big portion of your portfolio into a stock, because I understand it's been like one of the best businesses in the last five years. But what's to say the next 10 years are going to be different. And you could say that about many companies, by the way. So when you're investing, it's better to be safe than sorry. So that's how I would look at the 75% weighting. What about you?

Dave

16:00

Yeah, I would agree with that. And I think, just to kind of, I guess, hammer, the idea that Andrew was kind of talking about with the, you don't know what's coming, if you look back 20 years, and look at the top 10 companies in the s&p 500, only one of them still exists. And that's Microsoft. If you come back another 10 years, from today, going back 10 years, there's maybe half of them are in the s&p 500. Still, so a lot can change in 10 years, and especially when you think about technology, and how quickly things can turn, I don't think any of us need to be reminded of how quickly apple became the iPhone became the thing to have, when not that long ago, it was, you know, having the like a Blackberry. Yeah. Thank you.

Yeah, the blackberries are the flip phones. Those were the phones to have. And Apple came along and was so vastly superior, that those phones and those companies quickly became obsolete. And in videos kind of the same idea. If you even just look at the semiconductor world, just in general, Cisco, companies like Intel, were at the top of the mountain. And now they're not well, Cisco kind of still is, but Intel definitely is not. And AMD is past them. And keep in mind, these companies have all been around for 3040 50 years. So they aren't new companies. Same with Nvidia.

They've been around for 30 or 40 years, I believe. And it's a great business, and I'm not detracting from the business, the guy, the CEO that runs it is a really, really smart cookie. And all three of these CEOs, if you had to rate them are all excellent CEOs that run the companies. You know, Elon Musk has his challenges, Sally say, but you can't argue that he has built a great company. And like Andrew, I'll echo that I was wrong. And

it's you know, far exceeded my expectations of five years ago, for sure. And so having those stocks run up all that much that I'm sure you've seen, since you've owned them has probably been awesome. But the thing you have to remember with all three of them is that we don't know what's on the future.

You don't know what is coming. And none of us can imagine something that could be better than the iPhone, you know, some 19 year old kid out there right now is probably imagining that very thing, and could be creating it right now. And we just don't know about it. And Tesla, as great as they are, there is a lot of challenges coming for them. All the major car companies are quickly accelerating their, I guess, embracing of electric vehicles, and it's becoming a thing. And it's not just here in the United States, it's in China. It's in Europe, it's in Japan, it's it's all over the world. And so how will Tesla fare in five or 10 years? I don't know why I don't think any of us know, you can't deny that it's done well up to this point. But we'll continue to have that same success over 10 years. History says no, but you know, Elon Musk has proven that wrong many times before. So I for one would not bet against that.

But that being said, having that be 25 or greater percent of your portfolio, especially when you have three companies like that. Maybe if you had one that was that much, that would be okay, but having three, that's a pretty stiff percentage. And like Andrew said, if any of those three go down a lot, you're going to struggle to get back to even for a very long time. And so that's where the risk comes in. I guess the next question then is what do we recommend that Rachel does? Like, how should she handle that?

Andrew

19:27

Well, I'll put it this way. If it was me, right, yeah. I remember having a portfolio that I didn't particularly like, and instead of doing a radical change, I made slow changes over time. Part of that was shifting my strategy more towards long term rather than short term value getting better companies, but you know, if obviously, it's totally up to Rachel what she wants to do. If it was me, and I was trying to more diversify my portfolio, it's probably something. Again, I would probably try to do over time, especially if I was trying to pick my own individual stocks because it takes time to get to know companies. And a lot of them are not great values a lot of the time.

So that kind of stuff goes in and out. And that's probably how I would look at it, or just sell low enough to be comfortable and then put the rest into an index fund, that's a very easy way to do it, too. I totally understand the idea of like, being 33 years old, don't have to retire till 65 translation, I can handle a volatility, right. That's the rallying cry of holding on to really expensive stocks. But I would really caution against that, because it's the same story, just different characters every time. And we saw it in 2021. We saw it in the.com, boom.

And you just have to be careful. If you look at the number of people who say that I have a long time horizon. So I'm just going to hold on to a stock. There's very few long term survivors of people who actually did well, with the strategy like that the price you pay does matter. And we're all concerned to remember that again.

Dave

21:02

Yep, totally. That's good advice, I think that's probably, I would probably go with the same option, I would probably sell some of the positions of the three and try to reduce your holdings, and then maybe add them into other holdings that you have, I think a lot of people sometimes spend a lot of time, probably more time looking at other companies to invest in, as opposed to getting more knowledgeable about the companies that they do own.

And I think once you get more knowledgeable about the companies you do own, then it could give you a lot more comfort on whether you can continue holding that position or whether you want to add to that position, or whatnot. And, you know, I have two companies in my portfolio that are like 20 22%, and like 15%. And I'm comfortable with that. But I'm also working on building up the other percentages so that those in time will become less of a bigger size of my portfolio. And that's the only thing that you can look at doing as well. I know you said you don't have money at this time to add to those other positions. But maybe as time goes on, you can do some of those things, too. But I don't think you need to make any drastic changes today. I think, you know, the slow and steady approach that Andrew was talking about, I think is probably the best way to go. That's the way I would do it.

Andrew

22:21

And that's the way he told me to do it. And that worked really well because it's easy to get like gung ho about wanting to change direction. And you have to be careful doing that, because it takes time to make good individual stock decisions. And you don't have to do it all at once because stocks are around almost 24/7 Yes, they

Dave

22:38

are. Yes, they are. All right. Let's move on to our last question. So I have Hello, thank you for your great articles. And today just purchase your investing tool package. I have created a pretty elaborate model for valuing companies, but have been a little cloudy on one issue. I am of the opinion that not adding SPC

which stands for stock based compensation to cash flows is the right way to go when performing a DCF. And I do this in my model.

One unique aspect of my DCF model is it forecasts the DCF value per share for future periods, whereas most DCF models just present the current value. What I like about this is it gives me an idea of what a stock might be worth at any future point in time, one to 20 years from now, here's my question. It seems that because I am not adding back SPC to those future years, I should also not be attempting to adjust the share count for any expected dilution. It seems correct to adjust for expected buybacks, but not for stock issuances related to SBC. Does this logic seem correct to you? Sorry, I'm out of message base. Shawn. So what are your thoughts on Shawn's? Great question?

Andrew

23:44

Yeah, Shawn, I think it's really cool that you've created your model. I like the idea of looking at it out multiple years and kind of visualizing the intrinsic value of that changing over time. I think that's really cool. It is, in my mind, if you're adjusting stock based compensation in the cash flow statement, I wouldn't adjust the shares outstanding, because you're basically doing it twice.

You'd be double counting. So I agree that you would want to adjust shares outstanding based on how much buyback supersede I do that personally, and really, you don't see that talked about much, which kind of shocks me, but I don't think you would have to dilute the shares because, again, the numbers don't show up on the cash flow statement. are trying to project what that cost is to the company in the future. Um, I guess on your end, Dave, looking at the free cash flow, the firm side, if you're looking at DCF model like that, how does that fit in? Or is it a similar idea?

Dave

24:43

Basically, the way that I do it, and this is what I learned from Professor to motor and was that you don't adjust the share count at all. And when you look at the stock based compensation, you basically, you look at what the value of all those shares are outstanding. And then you subtract that from the total value of the company. Let's say that you look at the company.

And just for ease of numbers, let's say that the value of the company is $1,000, after you're done with your DCF, then you would look at the value of those share based compensation that has not been exercised. And

you look at that and go, Okay, that's worth $100, then I would subtract the $100, from the $1,000 of the total value of the company. And then I would divide that by the shares outstanding, and that would give me the value of the company. So that's how he approaches it. And that's how I kind of like to look at it as well, is that it's in the cashflow statements, it's being adjusted already. And so we're accounting for that.

But I've said this before, stock based compensation, whether you account for it or not, it is money that you owe somebody. And at some point, it's going to come due unless they don't exercise their shares, which I'm going to guess about 85 to 90% of people exercise their shares, at some point, it does have an impact on the value. And so whether you subtracted at the beginning, or whether you subtracted the end, you have to account for it in some way, shape, or form. And so I think if you add it back in, then you have to account for the shares. If you don't add it back in and you just leave it out, then you can just leave the shares as is, but you have to account for it somewhere along the line in the valuation because it is, it's like debt, it's money, that does have an impact on the value of the business.

Because if the business gets sold, then that has to be accounted for the people buying the business have to account for that contractual obligation in one shape, way, shape, or form. And so those are things that you just kind of have to consider, you know, I like the simplicity of the way that he does it, because it doesn't get into the possible convolution of adding it back in and then you know, increasing the shares, and then taking the shares back out. And just any of that kind of stuff. It just, it leaves the shares the same, but it subtracts from the value of the business kind of like a debt that looks at it like it's a debt. And that's the way he looks at it. And that's his way, I kind of like to look at it as well.

Andrew

27:07

Yeah, I would just point out, I mean, I've seen it visualize in my head, because Dave and I have done so many of these spreadsheets, but maybe it's confusing for somebody who hasn't seen the two spreadsheets that we share on the package that we sell. But I know for you, Dave, yours is primarily going through the income statement. And using some of the balance sheet, whereas mine looks at the cash flow statement. So we're really, we're using the same financial statements, but at different places to arrive at the same place. And so what they've saying makes sense, if you're looking at the income statement, which is a free cash flow to the firm model, when I'm saying when I adjust the free cash flow from the cash flow statement that makes sense for free cash flow, the equity model.

So again, you can do one way or the other. And it's confusing, but once you get it, you're like, oh, that's actually kind of nice, because then you can almost double check your valuation.

Dave

28:02

If you want to go on Twitter and start a fight, all you have to do is just say stock based compensation. And that's it. And then you're gonna get, you know, Angry Birds from all different kinds of directions. So it's a very polarizing subject, it is something you have to tackle, especially depending on what kind of businesses that you're investing in. If you're buying more younger tech, heavy businesses, stock based compensation is going to be a very, very big part of the financial part of the business, and especially early on in the business, and you're going to have to account for it because it is a very big cost that those businesses are taking on.

Whereas if you're looking at a company like Wells Fargo, or Walmart, or even Amazon to a certain extent, there is stock based compensation. It's way way smaller portion of the financial business. And so it's not necessarily something you need to concern yourself with overly, but if you're looking at a company, like I don't know, you know, Mongo, MD DB or square block now, even Facebook, you know, these companies that are spending a lot of money to attract talent, are using stock based compensation as a means to attract talent. And but you have to account for that when you try to value the company because it is a cost of the business at some point in time. Yeah,

Andrew

29:21

I mean, Buffett had controversial things to say about it in 2003. Here we are 20 years later, and it's still a hot topic on three. I think that's funny.

Dave

29:30

Yeah, yeah. I think for a long time, it's going to be until they change the accounting rules, which happen about as fast as glaciers moving until that changes. Yeah, this is going to always be kind of a controversial topic. All right. Well, I guess with that, we will go ahead and wrap up our conversation for today. I wanted to thank everybody for taking the time to send us those fantastic questions, keep them coming.

Those are a lot of fun. And hopefully you guys got some good information about our discussions today. If you have any questions about anything that we talked about today, and I'm sure stock based compensation, we'll probably be high on the list of that, go to our website e investing for beginners.com search bar at the top of the page, can't miss it. Type in stock based compensation and you're going to find all kinds of great articles that will help you learn more about that topic, as well as all the other stuff that we've discussed

today. So without any further ado, I'm going to 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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