IFB246: How to Use Relative Valuation + Investing in New Companies or Current Portfolio

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Dave

0:00

All right, folks, welcome to investing for beginners Podcast. Today we have episode 246. We have four counting for great listener questions that we're going to answer today. So without any further ado, I will go ahead and dive in. And we'll start with the first one. So this is from our friend stash. We answered a question from him a little while ago, and he wrote us in asking us for further clarification. So here we go.

So hi, guys. On my way to work this morning, I was surprised to hear you read the last question I sent to you. I honestly didn't expect a response hearing, it really made me appreciate the service that you were doing and trust your intentions and teachings that you provide. I wanted to follow up because it wasn't clear enough about my 401k. I had said that I had a 10% match. My company handles its 401k a little differently than most that I've heard of. It's not a public company, the 10% I'm speaking of is my company's match 10% of what I put in. So if I put in 200 hours a week, they put in 20. I was wondering if this clarification changes your thoughts on my previous question, if it was 100%, match up to 10%?

I agree with what you said. But since it's a little different, I was wondering if you could take another look. You guys are awesome. Again, thanks for what you do. stache. So Andrew, what are your thoughts on stashes follow up question to an earlier question that we answered, which I thought was really good,

Andrew

1:14

I would still stick to the same advice because 10% 10%. And it's really, really hard to beat the market by 10%. So if you can get 10% right off the bat, and then just put it in an index one or something that's going to be a lot better than anything that probably most people can do.

Dave

1:34

I would agree with that, too. If you're less you are the next Warren Buffett, I think you're taking that 10% that the company is giving you again, it's free money. And you don't have to do anything for that 10% other than work there for them. And they're gonna give you 10% back, which is it's a great feature. And it also continues to help build your wealth over a longer period of time that 200 bucks a week that you're putting in is going to compound. And if you're putting it in with to say an s&p 500 index, it's going to compound at 10% a year for the next 50 years. That's great.

And that extra 20 bucks, a week is going to add to that piles in that snowball that Andrew has talked about in the past. So by all means, I will continue to do what you're doing stash. It's awesome. And it's a great way to continue to invest.

Andrew

2:17

Yep, I agree. So the next question. Hi, I've been a subscriber since earlier this year, I am 51 years old, I have a 401k and four rental properties. Otherwise, I'm debt free. I have been following the portfolio purchases and picked up extra from the list you have very happy. My question is with prices dropping Is now a good time to buy extras. If the stock prices are dropping below my original cost, I have about an extra $2,000 a month I am allocating.

Dave

2:44

So that is a fantastic question. Especially with everything that is going on in the markets. Lately, we have seen a pretty drastic drawdown across the board. And there's the phrase, you know that you can always tell who's been swimming naked when the tide goes out, you can also see that the tide will raise all boats, it also will lower all boats.

And so right now, the thing that I guess I have personally been focusing on is looking at my portfolio. And when I reinvest or invest, I've noticed that instead of looking for newer names, I'm really looking at the companies that are already own, and assessing whether that is the best opportunity other than going out and trying to find other names. So I'd be curious, I know you're going through this exact scenario. So maybe we could talk through that a little bit.

Andrew

3:32

I totally am. So in my monthly newsletter, the sailor research Eli there, we have a sell order that we are doing. And I guess it is a spoiler alert, but by the time this goes live subscribers will have already seen it. But we are going to be selling a company called store capital because it was just announced that they were going to be acquired. So rather than wait for that to happen, the price is pretty close to what the end deal is going to be we're going to take that and allocate it so I have an extra. So this real money portfolio does $150 a month.

So each month $150 is going in this is going to be an extra $750. So about $900 allocated which is more than I usually do per month, obviously. So I am going through the same thought process. And I struggle a little bit because famous phrase we like to use it depends, because of the way the market has been lately, and like you said and like this listener said the prices have been dropping a lot. It makes me look at the portfolio and see that there's a lot of good quality names that have dropped and other it's gonna be a good time to add into. And so it really depends if you're listening to this, two, three years down in the future. Maybe the market is so elevated where there's no way at all you would ever find three or four quality names to put money into because everything's so expensive. And so I've dealt with that in the past to where I just basically rolled in the extra money into whatever the position was at that time. And that served me very well at that time.

But I don't see myself doing that now, because there are super high quality names in the portfolio now that are good to allocate. So I wish I had like a all encompassing universal answer for what you do when you have extra to allocate each month, I would say it probably depends on what companies are down, why are they down, and kind of taking down on a case by case basis. So for example, with the market, we've seen, interest rates have gone higher, which pushes, that lowers the tide that make all boats go lower, because interest rates, when they go up, stock valuations go down.

And so that's one factor that keep in mind. The other factor is, why is your particular stock that you're looking at going down? Is it because something has fundamentally changed with the business? Are things worse for them? Because of some outside factor? Or are they down because all boats are down? So those are the questions I would ask if I was trying to decide whether am I going to put these into the best companies in my portfolio? Or am I going to allocate it all into one or somewhere in the middle.

And so that's what makes it hard. When you're following the newsletters, you don't always get all those answers, and everybody has a different financial situation. But when you're invested, you have skin in the game, you can start to pick up some good insight, and I hope to provide that through the newsletter.

Dave

6:30

And you do. And these are all questions that people are going to have, especially if we continue down the path of a bear market. And depending on who you talk to the NASDAQ and the s&p are unquestionably in a bear market. And the Dow is flirting with it, and has been flirting with it for a while. And so it's kind of hard to decide exactly where to go. I guess the thing that I've been thinking a lot about is I pay attention to earnings. And I pay attention to earnings calls and reports and whatnot, not necessarily for long term view of the company. But just to make sure that the engine is still humming.

And perfect case in point is Berkshire Hathaway. So it's recently had gotten close to my cost basis. And so if it had dropped below that I would have been like, you know, my fingers together super, like, Hey, I'm gonna buy more of this. Because when I look at the earnings and how the company is performing financially, it's still doing a great job, it's still doing everything it's supposed to do. It's just that the market is down and everything is kind of going down with it. But it doesn't mean that the value of Berkshire is less than it was yesterday, it's probably worth more, because it continues to grow. Its earnings, its cash flows, its revenues, the value of the business continues to go up, even though Mr. Market is saying, yeah, it's not as worth as much now that's the I guess the psychotic nature of somebody like Mr. Market is that they're going to be up and down every single day, but the business performance is still humming right along. And I guess that's the depends part of investing is you have to kind of take a case by case and look at the individual companies that you have, and decide which of these are the best businesses and do I want to give them more money to continue to allocate, that they can use to reinvest and grow their business.

And if they are, and they can, and they've done a good job in the past, and I believe they will, then for me, it's kind of an easy decision. But sometimes some of the companies you may not be sure of, and then it becomes a little more challenging. But there's nothing wrong with putting more money to work for a great

CEO is a great businesses, because over a long period of time, they're gonna give you you know, great returns in return.

Andrew

8:42

If anything, the best ones will allocate more capital when things are down. And so that gap between how good they are versus the average only grows as they're taking advantage of a tough economy. Yeah,

Dave

8:56

exactly. I'm blanking on where I read this. But I read somewhere recently, that one of the super investors was talking, it might have been Seth Klarman. He said that he looks at companies that lean into hard times like this. Because those are the companies when you come out of a recession or a dark time, are going to be the ones that are going to thrive in those times. So if they're reinvesting if they're hiring more people, they're allocating more capitals, instead of cutting things, that's generally a really good sign because that means they're building the business. And on the other side of a bad time is a good time. And that's when that company will really thrive during those

Andrew

9:31

periods. A very long term approach.

Dave

9:34

Yes. All right. So let's move on to the third question. So podcasts and progress start to finish currently in the 80s for episodes and number as of today, I'm an E letter subscriber. goal is to teach my kids what I wish I knew at 20 and give a headstart, Amen, brother, I heard your assessments of trn train and GPX in past episodes, funny coincidence, I've been in there rail repair and logistics industry now for five to six years. And I recently received consulting requests, I took them thinking that these people were trying to enter the nice part of the industry, the part of the industry that I dabble in and might offer a job. Instead, they're seeking a pulse on the industry as a whole, I believe for management of portfolios through a confidential interaction. Interesting timing, with finding your podcast,

I agree with your sentiment, keep emotion out of the purchases, and a balance sheet and intrinsic value should drive purchases. Do you feel this research is is an important component of protecting against loss necessary outside monitoring quarterly statements? Or where do you look, Steve? Alright, so this is a really interesting question. And this is something that we've actually talked a little bit about in the past between ourselves. So I'm curious to get your take that we can share with everybody,

Andrew

10:49

there are services out there, from my understanding, institutional investors will tend to use them, whereas more average, everyday investors won't, typically comes with a high price tag. And basically, a lot of them are trying to do that, where they're trying to get the pulse of the industry. So it's basically like, they interview you to get the pulse of the industry. And then you kind of not that you're sharing anything that's shippable. But like, yeah, it's like, almost like your locker room talk about the industry. And that's a great way to, like you said, get a pulse for the industry. So the question that Steve's asking here is, is a service like that, a necessary part of being an investor? Where, you know, should I be almost immersing myself in the industry? In order to make good investments?

That's kind of how I interpreted the question. Yeah, me too. And I think you can do it that way. I just say that the people that I have modeled my approach after, from what I understand, they don't necessarily do that. And if they do, do it, it's not the all encompassing reason behind the decision. Like, if I think of somebody like Warren Buffett, he might have people in certain industries that he can maybe communicate with to learn about an industry. But when it comes to, am I gonna buy Apple or not? I don't believe that he does that, based off something he heard from some engineer in the industry. I think he does that, because he looks at the financial statements. And the numbers make sense to him.

And then he has like a big picture reason why he invests in apple. And to be very specific about that is he's very public with everything he does, and is very much a teacher about where his mindset is. So when he talks about why did he buy Apple, he says, when he was in a Dairy Queen, I think it was, and he was with his two grandchildren. And he saw that they were just heads down in the phones, he understood, this isn't the technology, this is just like a part of people's lives. And that's what flipped the switch for him to look at apples financials. And instead of thinking, well, these are great financials, but maybe they will last for 10 years, he looks at it, like my grandkids, this is essential for them.

So he looks if it's essential for them, it's going to be essential for him as an investment for the next 10 years. So you kind of take a little bit of both, but to me, I don't see him as necessarily relying on it, and

necessarily needing it. And so for me personally, I also feel the same way. And I think for most investors, and the have that kind of scuttlebutt can always help. But I don't think it's necessary. And in certain situations that could become somewhat of a crutch, where you rely a little bit too much on emotions, and not so much on the numbers.

Dave

13:41

Yeah, I would agree with that assessment. And I love the Warren Buffett bring in who this and kind of how he looks at investing and whatnot, because that's really, what Andrew and I have really kind of based our whole approach on is how, you know, Warren and Charlie approach looking at investing. And the services that have become more popular over certainly over the last year or two, they do provide a benefit to people, and they can be helpful. The I guess the bigger question is, it can become a bit of a crutch. And it can also I found that it can be a little bit of a confirming bias, in some cases, because if you're reading about Company A, and they have four or five analysts that are talking or insiders that are talking about those particular industries or company per se, if they work for the company or work for the company, then they are going to be more bullish about those companies and are not necessarily going to talk about the downsides of those businesses.

So I found myself when I would read some of those that I would be taking on a more, I guess, bullish approach and it felt more like I was confirming what I already thought about the company. And in some cases, that's okay. But it could be dangerous. And that's why If you are using something, you gotta have to balance it out, figure out a way to counteract those potential bias. The other thing that I mean, it's definitely the Phil Fisher scuttlebutt method of investing. And it definitely takes a big swipe at the the qualitative part of investing. And that is important. But you can also get access to that in other ways you can do that by, for example, looking at Glassdoor and seeing how the reviews of the company the reviews of the CEO, and it's a free resource, it's something you can glassdoor.com.

And you can just see what people are saying about Tim Cook at Apple, and get a sense that way of the company culture without having to dive into all the nitty gritty of those kinds of things. The other thing that I worried about too, for me was that it could take away from me learning about the business itself, that it gets so focused on what all these people are saying about the business, that it would detract from trying to learn the quantitative part of the business, the actual business fundamentals, what drives their revenues, their costs, their pricing structure, their capital, allocation, all these things that are important, too. I felt like it could it was drawing me away from that. And so I felt like it could become too much of a crutch.

And I would put too much emphasis on three or four other people's opinions on the business as opposed to my opinion, or Andrews opinion, those things I felt like would be detracting are they a bad thing? No, I don't think they're a bad thing. And can they be helpful? Absolutely. But I think you have to kind of take it in measure, if you are using something like that, take it a measure with what you're reading, and kind of have a balance to it. Otherwise, it could become a dangerous crutch for you.

Andrew

16:46

And another investor, that kind of model that I think of as Peter Lynch. And he actually talked about how he does when he was running money full time, he did do this whole scale, a bunch of progeny, he was meeting people, three, four or five people a day. But he did mention that he would talk to competitors. And that basically, if he was interested in that company, and he was talking to that management, it was basically useless, because like you said, everything that goes into somebody feeling good about their own company feeling good about themselves, confirmation bias. But how he got a lot of good ideas from talking to competitors, saying, Hey, who do you think is the best in this industry?

They have no ball in that court, right? So they can speak freely. So that's one way to think about it. Like they've said, I think it could very easily become a crutch and something you would have to fight against. Which is why it sounds like you've decided not to use a service like that. I've also decided as well, but not to say it can't be helpful for certain types of investors.

Dave

17:45

Yep, exactly. And those are all great points. And I guess if this is something that you think is going to be useful to your investing process, you know, don't let Andrew and I talk you out of it, just try to think of it as how can I take these ideas and balance what I'm trying to do, and not get overly reliant on one source of information versus another. And if you're not in a position, financially, to afford some of these services, because the ones that I'm familiar with are not cheap. And so just for average, everyday investors that are wanting to do it themselves, it may not be in their situation, to be able to do this.

There are other free ways to do these kinds of things. For example, if you're looking at retail stores or grocery stores, you can easily just go to the store and observe what people are buying, you know, stand there for 10 minutes and just watch people and just see, you know, maybe not creepily but but just observe, you know, things that are going on. And you could even go talk to some people just walk up to them and ask them, you know, how was your experience at the store? Or go ask employees what they think of working at

the store? You know, do you enjoy working here? I mean, that's all I gotta do, you just walk in and ask them, Hey, how's it work in here, and they'll tell you, and those are little things that you can use to kind of help you make assessments on your own.

So you can also read reviews online, you can look at other websites like Seeking Alpha and get a pulse on the bearish and bullish cases for companies, because there's going to be Bufo, we're going to write about Apple and be super excited about it, and other ones that are going to be super down on it. And so you can kind of get a sense for the both sides of the story and then you can decide what you think is, you know, more likely so those are just I guess some other ways to approach this kind of, you know, information gathering that could help you make a decision. All right, so let's move on to the last question. So here we go.

When using relative valuations and multiples, should we consider using adjusted multiples example P E ratio can be influenced by whack and interest rates. Additionally price to free cash flow should we adjust this to include SPC which stands for stock based compensation, or does Mr. Market not care? So Andrew, let you take the first volley here.

Andrew

20:00

Okay, so relative valuations, what does that mean? That's metrics like the price earnings ratio, price to sales, price to book value, these are very simple heuristics for comparing one company to another. So I could take two companies in different industries. And I can say, look, all the companies in this industry are the P E of 20. All the companies in this industry are the P E of 25. The higher P E are more valued by Mr. Market. So that's probably a higher growth industry, or an industry with higher quality types of businesses. Those are the kinds of things you can do with a relative valuation. And then you can compare obviously, inside of that industry, a Mr. Market tends to like this company more than that company, because you can look at their PE or their price to sales, and say, Wow, a lot more investors are in this stock versus that stock, probably because they're the leader, or they're the best at what they do.

So I say all that because that's kind of the extent that I use relative valuations and also as a screening tool. So like, if you're doing a DCF, which is how you value a company, we've talked about that several times, I think it was IFP, 241 or 240, where we said, how do you value a company you can look at, that's how to do it. If a stock has a price to free cash flow of 50, or a PE of 50, something crazy like that, I don't care how I adjust the numbers, it's not going to be close to its intrinsic value. So I can automatically exclude a company like that. And so that's where the relative valuation comes in handy.

Because you can take a very numerical approach and exclude a lot of companies that you already know, based on what you're comfortable paying, the fees are going to be too expensive for me. And then from there, you use it to work in the next step of your research. And so I would not adjust these, necessarily, because if you're using it in the way I'm talking about as a screening tool, then it doesn't matter if you know, if interest rates are at like 12, and average PE is at like 15, then maybe that cut off is like PEO just with ours as an example, p of 20. Anything above a p 20. I'm not. But then if interest rates were at 2%. And the average price earnings of the market was 30, then maybe your cut off is more like a 35.

So the thing about interest rates and the whack, which is weighted average cost of capital that kind of gets baked in if you're using relative valuations in the same way, which is to compare companies with each other. So I would try to look at it that way. And I would use that as an opportunity to say like, if you're reading the Old investing book that was written in 1990, and they're saying, hey, every price earnings below this is a good stock, keep that in the context of interest rates at the time. So that's where maybe adjusting it can be useful.

But if you're using it to compare companies with the market, I wouldn't necessarily just because they're kind of all been subjected to those same factors,

Dave

23:06

the idea of relative valuation or multiples, for me, is something that I generally try to use as a screening process. And when I'm valuing a company, I'm always trying to look for the intrinsic value, which the only way that I can find it is by using a DCF. And so that's what I prefer to use, I understand where they're coming from with this question. And I guess there's two things I want to throw out there. So number one, if you're going to consider adjusting multiples, you have to do it for everything. You can't just do it for one company and not another. Because if you do that for Apple, you don't do that for Microsoft, you're basically confirming to yourself that this one's better than the other. And that's not an apples to apples comparison.

The idea behind relative valuation or using multiples is to compare them to others in their industry. And you also if you adjust it for Apple, but you don't adjust it for Wells Fargo, again, you're doing yourself a disservice. Because if you're going to do it, you have to adjust it across the board. And you have to be consistent to with whatever it is that you're doing. And I guess with the price to free cash flow, that kind of goes back to the whole question of do you include stock based compensation in your calculation for free cash flow or not. And if you do, then you have to, you know, you don't have to account for it, but you just

have to be consistent for it. And likewise, if you do remove stock based compensation from your free cash flow calculations, then you have to do that across the board.

And if you do something like that across the board, and you look at some of the companies that issue a lot of stock based compensation to pay their employees, you're going to be very, very disappointed with the multiples you're going to come back with because you're going to discover quite quickly that the majority of their free cash flow comes from the stock based compensation. And so it's they're not the businesses and not To the point where it's generating a lot, if any free cash flow at that point. And so you can kind of take that in consideration. I guess the other thing that I want to throw out there is Michael Mobizen, who is one of our heroes or finance heroes, he writes a lot.

And he's a very, very smart individual. And he's been leading the charge or part of the charge recently to, I guess, not necessarily adjust, but rearrange the financial statements. And some of his ideas kind of filter into what this person is asking, because one of the things that he's talked a lot about is the costs of business. Now, when the accounting rules were written in the late 80s, early 90s, and haven't been changed, the way businesses operate now are vastly different than they were at that time period. And so he feels like and a lot of other people in the same industry feel likewise, that the accounting statements don't necessarily correlate with the business results that you're seeing. And really, a lot of that really comes down to intangible assets, which in a lot of cases are things that you pay for, but you can't necessarily see or see a benefit from immediately.

So perfect example is expenses. If you look at expenses on the income statement, you see that those include things like r&d, for example, just doesn't single out one specific item. r&d can encompass a lot of different stuff. And in most cases, when you pay for r&d, you don't see the results of that for many, many, many years. But accounting rules require that you expense that out of the business, as if they've gained the benefit from that money that they spent perfect case in point would be Facebook, Facebook is spending a lot of money on the whole meta idea, like billions on the whole med idea.

And a lot of that is going through r&d. And so they're trying to build something, but their meta is not going to see or Facebook is not going to see the results of that for five or 10 years from now. And so the accounting rules, kind of punish this company because of the way that they're set up. And so Mobizen has been leading the charge to readjust the way that you handle an item like r&d, and maybe it increases the earnings on the income statement, but it reduces the invested capital or the assets that the business has. And so it offsets financially, when you look at the numbers, you may see a higher earnings ratio, but you may see a lower return on invested capital, because they have more assets, and will lower income.

So it just it kind of offsets each other. I think it's a beautiful thing. And it's I think he's right on the money with what he's trying to do. And I'm just hoping that sometime, you know, before I retire, the accounting officials will change their tune on this. But I think when you're thinking about something like this kind of stick to what Andrew was saying, you know, use multiples as a way of screening, and make sure you're consistent with what you're trying to do with the multiples. And I think that will take care of all the questions that you kind of have about multiples,

Andrew

28:05

I would say I mean, basically the whole adjustments things with Mobizen. He's talking about adjusting for basically kind of for DCF in a way you're using like ROIC to drive your valuation, for example, right. In that case, it probably makes sense to use your own adjustments. But if it's a relative valuation multiple, like PE or price to free cash flow, you're saying don't go through that. Yeah, I would say the same thing.

Like I don't adjust stock based compensation, if I'm looking at a price to free cash flow, and those are some screening companies. But when I'm doing the in depth DCF, how much is the stock worth? Then I'm definitely adjusting for stock based compensation. And I'm keeping that consistent with every stock I analyze. So yeah, I would agree with that kind of idea.

Dave

28:53

Yeah, that's perfect. Is there anything else we wanted to kind of touch on with this,

Andrew

28:57

I will add on this last thing, too, is there are a small percentage of companies where you do use relative valuation. So as an example, banks price to book is used a lot more than, like, you can't do a DCF on the bank, per se, you have to use a different kind of model.

And you can argue that super certain super cyclicals like a steel company where the earnings are just all over the place, you could argue that you would maybe want to look at price to book instead of where earnings or free cash flows are. So we're talking about those are probably in the vast minority of cases. So

don't take it as a blanket statement there could be use for relative valuations outside of what we've just talked about. But as a general rule 80 90% of the time 100% on adjustments and relative valuations.

Dave

29:54

I agree. Well said, I have nothing else to add. Okay. All right. Go ahead and take us out then. All right. So here we go. All right. Well, with that, we will go ahead and wrap up our conversation for today. I want to thank everybody for sending us those fantastic questions. This was a lot of fun. You guys keep sending us great stuff. And we love trying to answer them on the air for you. So we did talk about some technical things. We talked about some different ratios and terminology that may or may not be familiar to you, please check out our website investing for beginners.com.

We have this huge search bar at the top that has all kinds of answers inside that for you. So if you're curious about relative valuation, or multiples or price to book or price to earnings, anything of that nature, you will find lots of information there to help you learn more about investing. And so E investing for beginners.com. With that, 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.

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