IFB249: Should You Use DCA for Individual Stocks or ETFs?

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Dave

0:00

All right, folks, welcome to Investing for Beginners podcast we have episode 249. Today, we are going to answer some great listener questions we got recently. So I will go ahead and get started. So, love your podcast, I wanted to offer some perspective about a question you discussed on FB two four for an individual asked about DCAA. In an s&p 500 ETF, the two of you talked about some of the popular ETFs for the s&p which are SPY and B O, and how to use DCA dollar cost averaging to slowly build a position.

The perspective I would offer is that starting out with a small amount could be hard for those ETFs due to the cost they trade at $377.03 $146 currently per share. However, there are a lot of low expense ratio mutual funds that track indexes that allow for a young investor to buy in for a set dollar amount. This can be helpful when the amount they have to contribute as well, and allows them to get invested sooner without saving up to buy whole shares. That was kind of the end of the commentary. Andrew, would you like to take the first stab at kind of answering the comment and kind of, I guess clarifying where we were coming from when we answered that question.

Andrew

1:11

Yeah, sure. Thanks. Definitely for writing in very cool, I'm glad you're enjoying the show. If you're tuning in for the first time DCA or dollar cost averaging is simply investing the same amount of money every single month. And that's one of the best ways to get started and to arguably invest in general. Now these ETFs, SP, y and v Hello. Again, they're just basket of stocks that buy all the stocks in the s&p 500. The listeners saying that the dollar amount for those is pretty high. So if you were dollar cost averaging, if I was saving $200 a month, I couldn't buy a whole share of something like SP y, because it's at $377 a share.

To that I would say it depends on what broker you're using. So if you are in that situation, where the amount you're saving every month is lower than the shares you are trying to buy. Whether that's an ETF or whether that's an individual stock, find a broker who can do partial shares for you. Fidelity is one of the brokers I use, and I pulled up my individual brokerage account I put in that ticker spy, I said, Oh, is it gonna let me buy point one share, which is like 35 bucks.

And that totally lets you do that. So, again, not all brokerages do that I know, at the time we record, this ally does not do that. Merrill Edge does not do that. But fidelity does. So if you're in this situation, we would recommend I don't want to put words in your mouth, I would recommend the ETF over a mutual fund because ETFs gonna have low expense ratio period. So look for that. And if you are in that situation, look for a broker like Fidelity they do fractional shares.

Dave

2:55

Yeah, I would wholeheartedly agree. And yes, you could put word of mouth, I would agree with you have the exact same idea, the lower the fees, the better think of those as a hurdle rate. If you buy a mutual fund and it charges you 2%, then you have to do at least 2% Better to earn any money every single year. And the market will tell you that historically, over a long period of time, it will return in the tennis range depending but there are going to be fluctuations are going to be years like this year where it's not so much your s&p 500 return is not going to be so great, then you would also have the additional 2% hurdle rate to get over that.

So I think the s&p is down well, maybe not today anymore. But as we're recording today, the market is having a bit of a dead cat bounce means that it's going up artificially, we think but who really knows. But I guess my point with all this is that the market has been down 20 25% this year. So if you buy a fund that's tracking the s&p 500, and it's charging you 2%, then you have to do 22% To get back to even not just 20%. So that's something to consider. And so when you're talking about any sort of funds, whether it's index funds or mutual funds, trying to find the ones that are going to offer you the lowest fees are going to be something you definitely want to look for, because that's going to help you increase your returns. You may think, Dave, whatever 2% Big deal. But if you do that over 20 years, that's 2%. It's not compounding for you. It's compounding for the other person that's taking that 2% from you so and over a court. I don't know the math.

But if you look at that over a course of a 20 year period, that's going to end up being a nice big chunk of change. Yeah, all right. So again, thank you for sending that commentary that it's helpful information. If you're in a brokerage account that does not offer that then yeah, that's something that considered I appreciate you pointing that out. And anything that you guys see that we have additional commentary, please feel free to send it our way, and we'll share it as needed. All right, so let's move on to the next question. So we have i Guys, I have been a listener of the podcast for a while now. And I'm finally committed to opening an investing account. Hold think the dollar cost average in some index funds? Would you recommend investing a sum of the money I currently have saved into the fund before the beginning of the monthly process, ie adding $100 a month?

Or shall I simply start the journey with the first $100 investment? And we've would I currently have saved for other things? In addition, would you recommend using dollar cost averaging to invest in other companies ie investing in Apple slash Tesla? Or should dollar cost averaging only be used for ETFs slash index funds? Thanks so much for all your help, guys. Oh, you provide Troy? So this is a great question, Andrew, I'm gonna give you the first take at it sounds

Andrew

5:35

good? Let me have the first crack. Yeah, thank you. So to me, it's not clear what the extra funds are. Obviously, we always advocate, get started, do it. As soon as you can. Try not to put excuses in your head and just start moving. This isn't a game that you have to have figured out from day one, when you start doing it. That's a lifetime journey. So the sooner you can start, the sooner you can make mistakes if you have to, or simply get comfortable with what works best for you. So I would definitely at least just start that dollar cost averaging process, do not overcomplicate it, as far as what to do with the money already saved for other things. If it's already in an index fund, I would probably just keep it in there.

Because if you're buying individual stocks for the first time, you're not gonna be good at it. Some people, I definitely had beginner's luck when I first started. And I think a lot of people do. The danger in that is you start to think that you're better than you are. And that can become expensive when you are humbled. That's not to say you can't be good someday, but when you're first starting, it's very unlikely you'll be good. And just because their stocks are going up doesn't mean you're good. And it just means beginner's luck.

So, you know, if you got a bunch of money, then index fund, I probably wouldn't touch it. Now it kind of just slow and steady trying to grow your individual stock portfolio as you grow your own investing skills, stock picking skills, if it's saved for other things, now, you're kind of breaching into the personal finance arena of I don't want to have this saved for an emergency fund don't want to have this money saved to you know, sinking fund almost like I'm going to buy a big thing later. That's kind of out of the realm of what I try to really bring expertise to.

And I would say that's more personal. But as far as if we're the assume the questions asking what do I deal with money that's already in an index fund, I will keep it there. And then if I'm trying to do individual stocks slowly and steadily build that up, but don't be in a rush to have it all figured out and think you're the best investor because it's not likely.

Dave

7:37

Unfortunately, we most of us don't come out of the womb as Warren Buffett or Charlie Munger or add great investor here, most of us have to learn through the process. And like you, I was lucky out of the gate. And then I bought some other things that I was not so lucky on, and did quite poorly on and it will humble you, for sure. The market always comes knocking. And Mr. Market is crazy person. So they will come and offer you great deals one day, and that's a great the other deals, and I'm very happy that Troy is starting, that's cause for celebration. And I applaud you for making the commitment and starting to do this because this is going to be your path to financial freedom and wealth. And if you look at over the history of time, the richest people in history, have all owned one thing, and it's all been businesses, whether it's their own, or whether there are others.

That's what they've owned. And that's the way that you get wealthy is by owning a business. You know, unless you're lucky enough to be part of the Louis Vuitton family and marry are born into the you know, get the ovarian lottery, as Warren Buffett likes to say, I guess you know, the other thing is when I think about people that are starting, or maybe they're on the fence or whatnot, the Warren Buffett likes to say the the best time to plant a tree was yesterday, the second best time is today, and is getting started, it doesn't matter that you didn't start yesterday, we're always going to find excuses, we're going to, you know, find excuses, we're going to wait for the war in Ukraine to stop, we're going to wait for all the hullabaloo about 911 to die down and we're going to wait for inflation to go away, or we're going to wait till we get this new job. There's always a reason.

And there's always an excuse. But the sooner that we can start, the sooner we can get where we want to go. And it's not always going to be easy. You're gonna make mistakes, but part of making mistakes is part of the learning process, as long as you take it that way. And you continue to learn from those mistakes and continue to, I guess improve. So I guess part of his other question that I'd like to kind of get to as do we advocate dollar cost averaging only for ETFs slash index funds, or stocks? Or both? Or how do we think about that?

Andrew

9:39

I'm almost interpreting it. Like, if you wanted to buy Apple, do you buy it six months in a row kind of a thing? Or Tesla or whatever the stock is? And I feel like that's been the age old question that we've tried to answer several times. I don't know how would you look at that?

Dave

9:55

It's a hard question. I think the way that I guess I have looked at it and try to look at it is trying to build up my portfolio name by name to a point where I get comfortable with the numbers that I have. And like right now, I think I have 14 companies in my portfolio. And so instead of trying to expand on those 14 Right now, with the market being the way it is, I'm trying to put more money into the names I already own, because arguably, those are the ones that I know the best.

And so that's kind of the way that I've been trying to approach it, especially because some of the companies that I do own have been beaten down a little bit by Mr. Market. And so they're offering I feel like are really good deals on those companies. But I personally have never bought a company six months in a row, you could argue that, you know, we all should have been buying Apple, Microsoft, Google, etc, over the last six months, every month in a row, but Well, up until recently.

So I think I mean, it's an interesting question, it kind of comes back to it depends, you need to do what's going to work best for you. I guess my suggestion, and a way that I would approach it is if I was in Troy's position is I would find, I would invest $100 Every month into the best investment that I could make that particular month. And if it happens to be Apple for three months in a row, then I would buy Apple for three months in a row. And then if the next month, it's maybe you know, just insert name here, Visa, or it could be anything, then I would buy visa the next month, and then maybe I would buy another company and just kind of gradually try to build it up.

You don't have to get 25 positions overnight. It is not a race. And so I guess that's the way I would approach it. I'd like to hear from Sir Andrew on how he would approach the idea.

Andrew

11:37

One of the things I did right when I started the real money portfolio back in 2014 was $1 cost average into a new stock every month. And so you know, Dave talked about having 14 positions, that's a pretty balanced, diversified portfolio, like you said, to have a diversified balanced portfolio from day one, it's just not really going to happen. And if it does, you're probably buying some companies at a higher price than you should. So I totally agree. Look at what the best deals are out there. But if I was Troy starting from day one, if there was one thing I did, right, it was building that portfolio with diversified names, first and foremost.

Because even the company is great as Apple would not have been a great investment, depending on what price you paid. And you know, you can argue with hindsight, well, you could have bought apple at any price. And that would be great because of how much it's risen. But it all depends on what time we're talking about, right? I mean, I struggled to find a stock where you could have bought other than the price and it would be okay, outside of like the Tesla's of the world. But then again, 510 years from now, as a company like Tesla, is that still gonna be true for a company like Tesla? It sounds really complex, right? And it really is like, who's defining the starting line? And who's defining the ending line?

So all that to say is there's no right or wrong answer for any one stock when you're buying it. What is a wrong answer is if you load up on Apple, six times in a row, and then it's one of those time periods, it's not a good time to buy Apple. And now you feel like you are a bad investor, because you made one mistake. And so just like you can have beginner's luck, you could have bad luck in the beginning, and think that means I'm not like an investor. And that's not true at all. So for me, I would want to caution just try to build a diversified portfolio. And then once you're at 1520 25 positions, then maybe you look at it a little bit different. I would try to make things diversified and balanced and be flexible with what your idea of a good investment is and what the reality actually might be. And don't be afraid to look for help, too. Yeah,

Dave

13:49

that's perfect. That's a great answer. All right.

Andrew

13:51

So moving on to the next one is the tail end of one of the questions we got. So I'll just throw this one in here. There are platforms that do valuation, like Gurufocus, for example, their valuations are slightly different than yours. Can you address the utility of these types of sites for those of us who struggle to do valuation on our own? So they have like, what's valuation for somebody who has no idea what that means? And then how do you approach this question?

Dave

14:17

Yeah, okay. Yeah, it's a great question. So, valuation, for those of you out there that are not familiar with this term, basically, what it means is we're trying to determine the intrinsic value of a particular investment. So I think the easiest way to describe it is, think of a car. When you go to buy a car at a car dealership, you have in mind, a value you think the vehicle that you're trying to buy is worth, whatever that may be, you may or may not have done due diligence and IE looked at Kelley Blue Book or other websites online to kind of get a gauge for what the prices are for that particular vehicle. And then when you go to that dealership, you can determine if you think that the eldest use $30,000 is a fair price for that car, then you can decide whether that's something you want to buy or not.

Same idea applies with buying stocks, you have to determine whether you think the value of that company is worth the price that it's selling for in the market, you have to think about the market is basically selling plays, there's somebody buying and selling shares of Apple every single day. And Mr. Market is there to present them to us as a deal or not a deal. And so our job is to try to figure out, when he comes knocking at the door, is the price that they're offering me today. Let's say it's $140, just as an example, do, we think that's a fair price.

And if it is, then we can buy? If we think it's too expensive, then we can pass? Or if we think it's really cheap, then we can buy more. So it really comes down to that. But valuation is the method that you would use to try to determine the value of that particular company. Does that help kind of clarify you think? Oh, yeah. Okay. So there are websites out there that offer help to figure out how to value companies. And I think that some of them are great, some of them are probably not so great. And I'm not going to pick on people, that's not my job here. But one of the things that I will say about Gurufocus is is a site that I have used a lot in the past, and they have a valuation model on there. And I used it from time to time I moved away from it, because I, as I learned more, I just felt like that there were better opportunities to find ways to value the companies. And without getting into the nitty gritty of it.

The refocus has a different philosophy, I guess you would say, of how to assign a discount rate. And without boring everybody with numbers and whatnot, a discount rate is basically a way of thinking of a hurdle rate that you want to invest in. So if somebody says my discount rate is 8%, then you need to make better than 8%, for it to be a good return for you to invest in that company. And so that's kind of the way you can kind of think about it. And so with Ben in particular, with Gurufocus, their idea to establish a hurdle rate I don't necessarily agree with and so that's why I kind of moved away from the platform. So I guess, what are your thoughts on like websites that kind of use this and those kinds of ideas? So like,

Andrew

17:23

what's the downside to when they mean, they had you set a hurdle rate? I guess for clarification, I also used to use the tool that I thought was a great learning process to learning valuation, because it's very, very simple. Yes, it is. But I don't I don't know if I remember this setting discount rate. So what do you mean, by

Dave

17:40

the way that they did it was instead of when they there can be some math involved in creating or establishing a discount rate. And one of the things that they did was instead of adjusting it for interest rates that are going on globally, they set it at a fixed amount, and then everything else or rally Yeah, did changes sidebar there equity risk premium was 6%, no matter what was going on in the market. And so once I learned that, I was like, Yeah, okay, no.

Andrew

18:09

Sidebar, like we're not recording this right here. Yeah. Okay. Isn't that the risk, they add the risk free rate to it, don't they? They do

Dave

18:15

the wack formula, but instead of, you know, going by kind of like what dama Doren does is an adjusting it based on they just it's 6% all the time, it doesn't matter what the interest rates are going on around it. So the equity risk premium for their cost of equity never changes. What's wrong with that it doesn't account for the 10 year rate moving around, Andrew

18:34

I'll have to look, I thought the 10 year rate is added and then it's added to equity risk premium.

Dave

18:39

It is it part of the equity risk premium is the tenure rate. But it's also part of the risk premium that the market sets. And so when there's a lot of volatility that goes up a lot, and so perfect example is a few years ago, the ERP that dama Doron set was 6.5 6.7. And so that drove up the rate the interest rates or the the discount rate a lot. And when they just set it at six, it doesn't account for the fact that the rates went down to zero at some point.

So yeah, but there's an ERP supposed to be like a long, Allah, it's supposed to represent your required return for doing equities versus like bonds, right. So if historically, equities have outperformed bonds by like five to 6%, then can you just hold it there rather than adjusting? And every year? You can? You can, I mean, it's just a matter of, so I do. I mean, it's just a matter of opinion. I just, I kind of like the way Dumbledore and does it by he just did it according to the interest rate, that you know, the 10 year rate that's being set, so that he feels like it's sometimes the minute you know, but if you look over like the last 50 years, because he has a chart over the last 50 years, you can see some pretty wild fluctuations depending on where the 10 year rate was.

Andrew

19:56

So if if the 10 year rates temporarily dislocated and when that mess up the ERP. Yeah, because so anytime there's like a yield inversion member the deal done, because that's not really where the tenure supposed to be right? To me, I think bottom line, I think the evaluation tool can be helpful. But I wouldn't use it as an end all be all, because the tool is really only as useful as the person who's using it. I know if you're like new to investing, that all sounds kind of weird and kind of crazy.

But there's a lot of truth to it. And I really liked that car example you mentioned earlier, because I kind of look at it like, you might look like a Tesla or a BMW, you know, a taxi, or Beemer and to some people, that's like a fair price to pay for a car like that. And other people, they look at you like you're insane. And a lot of times you have stocks like that. But at a certain if you go down the price scale on cars, at a certain point, there's a certain value that I know this car is gonna get me this many miles. And outside of the bells and whistles, it's a good price for me, because I know I'm gonna get this many miles. And I think you can think of stocks in that way a lot too, because we can all disagree on whether Tessier beamer is better. But what we can't disagree on is what the business is producing, what are the miles it's giving you and for businesses, its cash flows. And so that's where valuation comes in. And that's where guru focus is trying to teach you, we have a tool that tries to teach you what's called the little package evaluation. But until you understand the nuts and bolts of the cash flows, then it is really hard to do evaluation.

And so there are a lot of different shortcuts to valuation, which I think can be very, very helpful. Things like price to earnings, and price to sales. And these are things we've all covered in our archives, if you go back to our previous episodes, so you know, you don't have to know how to build a car to drive the car. But it helps a lot to understand why cars are being priced as they are when you understand the nuts and bolts. And so that's I hope that's helpful in the sense that like, it doesn't matter how you get there, if you're trying to get there. And you don't have to know how to build a car necessarily, but it helps a lot.

Dave

22:17

Yeah, I totally agree. And without getting into the weeds of the particulars of learning this particular skill, it takes some time to learn some of these concepts and some of these ideas. And we have a lot of great resources on the website that talk a lot about this. This is something that Andrew and I have spent a lot of time working through ourselves talking about amongst ourselves, the thing about valuation is it can be particular to each person kind of like Andrew was saying, Andrew and I agree on a vast majority of things that we think about when it comes to finance in companies we want to buy or whatnot.

But even he and I who have spent a lot of time writing and learning about how to value a company don't always, we have different ways of doing it. And it doesn't mean that his is better than mine, or vice versa, mine's better. But there's lots of ways to kind of eat this phrase to skin a cat. And there's lots of ways to go about doing it. And there's basic rules that you kind of need to follow. But then beyond that, it kind of comes down to what works best for you. And like Andrew was saying, he put it very well, what you think may think is expensive, other people may not and vice versa.

And the same applies to investing. And so anybody that's out there that's starting down this path, a Be patient, it's going to take some time be you will make mistakes, word knows I did and see keep at it, a water dripping on stone will eventually make an impression keep at it, you'll get it just takes a little bit of time. But one day, you're gonna be like, Ah, I get it. And it's going to be an awesome feeling. But just be patient with yourself. It does take time, and but you can do it. And so I kind of hope that kind of helps answer that question. So to move on to the last question here. So we have as a young investor, who has been following your monthly subscription, who has $5,000 to invest on top of DCA? Could you give me the benefits of owning ELE shares, compared to owning Google? Thank you. So I think we can probably insert any other company, Google or Microsoft or Berkshire doesn't matter. So what would it be? I guess your answer to this question, Sir Andrew,

Andrew

24:23

I would say first, it's awesome. You're young, and you're getting started. Second, you've got good disposable income, which is also when and third thank you for your business. I guess my hope is that you agreed the E leather and you try to ingest it. And if you've read it, its goal is to give you a reason to buy a stock and its risks, trying to give you a balanced reason.

And so if that company just hasn't done it for you, then I don't know what else to say because I literally that's the whole goal of that monthly ILA there. So there's a myriad of reasons why recommended that stock and they're in the leather, I don't know what else to say about it, I think on a broad big picture scale, it's looking for businesses that we're going to try to hold for a long time, it's buying businesses that pay a dividend, because that helps with kind of keeping management honest, we're kind of seeing what happens when that doesn't happen with Maeda. And it's trying to buy these businesses at a good price. And so not every stock is gonna end up that way.

But that's the principles behind the ELI there. And you'll be able to read in each issue, what makes this business have basically a competitive advantage or reason why it should continue to generate the cash flows under this. And so ELD is a great company, it's in a fantastic position. And there are all these reasons why we're buying it, and they are

Dave

25:51

in the issue. So I guess the way that I would look at it, this is a fantastic question. But one of the advantages to working with Andrew, and following what he's doing and helping him sometimes with some of his thoughts with some of these companies, is you get to learn how somebody thinks about buying different companies. And sometimes you want to look beyond the lessons of what the company is actually just the actual, like, I guess, first level pages by this company. There's other things to think about when you read about any company.

There's lots of great bloggers and writers out there that are read about a company that, for me, it's not something I'm going to invest in, but it is I can learn lessons from that. And those are other things that you can learn from the E letter besides investing in ELD. And when you try to think about building a portfolio, that's what Andrew is working on, is building a portfolio, and people can invest alongside him with their own money while he's doing his own money buying these companies. And they can build a portfolio with them. And you have to think about the principles that he's trained to create. And what he's trying to do, he kind of gave you a kind of a quick outline of these are the companies that I'm gonna buy, this is why I'm buying them, these are the risks involved in buying the company.

And that's very important. A lot of times, you'll get commentary about buying or selling different companies, but they don't give you the whole picture of what's good and what's bad. And it's sometimes just as important to think about the downside as it is to the upside. Because by not buying losers, you can win in the long run too. So there's advantages to that. And I think sometimes you have to kind of remove the Hey, I could buy this versus this kind of thing, because that could be an endless rabbit hole. And you can get stuck in inertia of never actually investing in something you can look at. There's an infinite number of myriad of number of stocks that you can invest in. But do they all offer a margin of safety?

Do they all offer a dividend? Do they all offer the ability to continue to grow over a long period of time, some of them may be short term, you know, awesome companies, you know, you could probably look at 10 Different companies that have been hammered since COVID, has receded and have not done very well that two years ago, everybody has said you have to buy this, ya have to buy this well, that hasn't worked out so well. And so that you have to think about where we're coming from. We're looking at guys like Buffett Munger, you know, those kinds of investors that have bought companies and held them for a long time, and have had kind of the same kind of principles.

When you look at each company that they buy, they all kind of have a commonality to them, whether it's Coca Cola, American Express, Apple BNSF, railroad, Geico, they all See's Candy, it just the list goes on and on and on. So I guess my point is with all this is that the E letter is not always just about the company you're buying. It's also about learning principles that you can use to become a better investor yourself, you know, over time. And as you learn more things, you can find other things that are going to be interesting to you that will help you become an investor. It's all about building a toolkit.

And that's what I look at Andrew is the letter is part of the toolkit that can help you become a better investor. Thanks. You're welcome. All right. So 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 and the great commentary.

Again, if there are things that you notice that could be helpful to our listeners, please, by all means, share them with us. We've asked you a few questions, kind of tried to get some feedback from you guys on different ideas, or different tools that we could share with our listeners. So those kinds of things are are always great. If you want to stay in the know on what's going on with our company with our business, or just find out what we're thinking, please consider signing up for our newsletter.

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