



IFB254: P/E and Growth Plus Using a Reverse DCF

[This transcript was generated by artificial intelligence. Timestamps are not 100% accurate depending on the platform used for listening].

Contact sales@advertiseicast.com to advertise on Investing for Beginners podcast. The Investing for Beginners podcast is part of the [Airwave Media](#) podcast network.

Dave

0:00

All right, folks, welcome to Investing for Beginners Podcast. Today we have Episode 254, we have one great question. And then we have a little thought experiment that Andrew and I are going to work through. So we'll start with a thought experiment first. So we got this great suggestion from Twitter to talk about kind of how you look at PE or price to earnings ratio and growth, and maybe thinking through how the different growth rates and a P E ratio of a company can impact the returns that we could get on a company.

So we'll do more of a high level as opposed to focusing on nitty gritty numbers, because it's kind of hard to do on a podcast, you guys can't really start looking up financials on your in your car while you're listening to the show or while you're on your exercise bike at the gym. So let's talk a little bit about price to earnings and growth, would you like to fill in our listeners on those kind of ideas, and then maybe we can chat a little bit about how this idea would work.

Andrew

0:59

I would love I feel like you do a really great job of explaining Pricer needs. So maybe for somebody who's listening for the first time, what's priced earnings, and then maybe we can talk about why that's such a common thing to look at when you're looking at stocks. Alright, okay,

Dave

1:15

I'll take a stab at it. So here we go. Price to Earnings is a ratio that can tell us a can give us a relative value of a company. And the way that you would calculate it is there's several ways and the easiest way for people that are new to looking at this is you can look at the price per share that you would find on your favorite financial website, ie stratosphere, that IO, which is what I would use, you could find out the price of a company, let's say it's trading at \$100 a share.

And then you would look up a metric called earnings per share, which is the bottom line of a company on the income statement is also called net income or earnings. And that number is divided by the shares outstanding, which gives us an earnings per share. And then we look at that ratio comparatively with each other. So if we have a company that's trading at \$100, a share, and we have a company that has \$10 earnings per share, then we would divide the 100 by 10, which would give us a P E of 10.

I guess the easiest most general way to look it up, you can also go through the financials and do it that way as well. But just for basic knowledge, that's the easiest way to do it. Of course you can, you can air quote, cheat, and just look at a financial website like Stratusphere. And they will tell you what the P E ratio is of Apple, for example. And the easiest way to think of this is in relationship to the ratio. So when we say a company is trading at a P E of 10, that means that investors are paying \$10 for every \$1 of earnings. And it's a relative measure that we can use to compare one company to another. And it's not a finite calculation to figure out intrinsic value of a business, it's more of a relative measure, because you'll hear is a very common term to use in the market to say the P E of this and the P E of this and compare companies, you know, from apples to apples and oranges to oranges. The one drawback to the P E ratio is that sometimes people will compare the PE of Wells Fargo to Apple.

And that's not a fair comparison to either company. Because both one company may seem more expensive than the other. And it isn't because they're not apples to apples, a much better comparison would be to look at Visa and MasterCard, for example. They're both competitors and roughly the same kind of industry. And so the P E ratio should tell you what's cheaper or more expensive. So that's kind of the I guess the basics behind the P E ratio and it's a great tool to use when you're first starting out to give you an idea of how

expensive or cheap a company may or may not be and generally, the lower the number the air quote, cheaper the company is and that's kind of the basics behind the P E ratio. Did I miss anything?

Andrew

4:30

No, I don't think you missed that. I mean, you pretty much covered the gamut of the basics behind P E ratio. A few other things up kind of popped to my mind when I think a P E ratio. Generally if a stock is more cyclical, which means their earnings, which is the E part of P e, if their earnings tend to fluctuate really to extreme highs and extreme lows, you'll tend to see those companies have lower p e ratios most of the time because investors now okay Hey, this company has high earnings. But this is a very volatile company, so they don't assign as much value to those earnings. Generally, companies that are more mature and have lower growth tend to have lower p e ratios. And companies with higher growth tend to have higher P E ratios. And that's because investors like growth, and so they tend to value stocks that are growing more with a higher P E.

Dave

5:29

Yeah, that's exactly right. I think the last caveat that I want to throw out there about PE is that, like Andrew was saying, when you're looking at cyclical industries, you're going to see wild fluctuations in those in that earnings denominator part of the equation. The other thing to consider too is different industries generally have different P E ratios, for example, banks, something like railroads, maybe construction, maybe housing, those tend to have lower p e ratios. Whereas if you look at things like tech, or some air, quote, more exciting industries, they may have higher P E ratios. Sometimes that's just because of the nature of the business.

And sometimes it's just a bias because people think that they're more exciting. So they're more valuable companies, and they're willing to pay more for the more exciting companies than they are for a boring bank, for example. And so you'll see higher ranges, you look at Tech landscape and a normal P E ratio for them, maybe 25. Or you look at the banking industry, a normal P E ratio may be 15, or 12. And so it's just it's, again, it's all relative, and it's all it's all something you have to think about and relate to what you're trying to look at that'll help with that. So let's maybe move on to the I guess the growth part of this idea. So when we think about P E ratios, and when you think about growth, how do you think about that. So

Andrew

6:55

there was a very interesting idea. And this is one of the books I recommend, if somebody's a beginner investor, called two books, both by Peter Lynch, he was a superstar fund manager from Fidelity back in the 90s 80s and 90s. Somewhere around that time period, he wrote a book called beating the street and also one up on Wall Street. And he had a very interesting idea around PE and growth. And before I get into it, let's just think about, like the big picture of P E ratios. I think a lot of value investors have talked about the idea that the long term average for a P E ratio for the stock market as a whole has been somewhere around 15 1617, something like that. So value investors will use that sometimes as a baseline starting point for thinking of the stock market as cheap or expensive. So if the stock market's PE of 20 value, investors might think, ooh, you know, maybe next year, the stock mark will be a PE of 13 to kind of balance out.

So you know, I'm thinking that at the PE of 20, it's expensive, and I'm not I'm gonna stay out. So not to say that that's the right thing to think about or the right way to behave. But that's kind of one of the anchors when it comes to thinking around P E ratios. So you can kind of apply that to stocks too, in the sense that if you're looking at a tech stock, and the P e is at 25. That sounds pretty expensive when the long term stock market Pease around the 15. On the flip side, if you're looking at a stock, the P e is at a 10. That sounds pretty cheap compared to a long term average of 15. Now, where Peter Lynch comes into this equation, and he makes it really, really interesting is he says, Okay, let's look at a stock, you can look at the stock, and let's say it is at a 25 P E, and that sounds really expensive, especially when you compare it to a stock with a PE of 10.

Let's say one stock sounds way more expensive than the other. But he makes the argument that if you run the math on a stock with higher growth, and the higher P E ratio, the end result will still be a higher gain than the company with a lower p e and a lower growth rate. And so it's the easiest way to visualize it's by like putting the numbers in the spreadsheet and then like having them grow over time. But that's basically the power of compounding, which makes a small number of earnings compound to something bigger. The bigger your growth rate, the more multiplicative effect you get, the bigger that snowball gets. And so that growth can come much faster. And so even if a stock like let's say, you know, Netflix used to be at like a 70 P E, and now it's trading more like a 30 but if along the way had compounded its earnings at such a fast rate, that even when the PE drops, it's still a good stock to buy. That's kind of the argument.

Because you know, if you have a stock that goes from a 70 pe to a 35, pe, your Pe is cut in half. And if the earnings are the same, that means your price cut in half. So you basically had the stock crash. So all else equal, your stock PE coming down means you have a pretty big drop in your stock price. So if you have a stock that's trading at 25, and eventually it crashes down to that average of 15 over the long term, then you're gonna have a pretty big stock drop. But his argument is, if the growth is big enough, then even after

that stock drops, the earnings have compounded to such a point that we're dropping by that's at a higher point. And so that's a better pick for a long term investor.

Dave

10:52

Does that help explain maybe why? Well, I wonder if that would help explain why I'd missed investing in a company like Amazon. Because when I looked at it optically, I would look at the P E ratio, and think, oh, my gosh, this is super expensive, because it was trading at a 70 or, you know, 50 7080. Pe. And you could argue that over the last 10 years, it's grown those earnings at such a fast compounded rate, that it would have been a good investment along the way, or could have been a good investment along the way. Is that kind of worthy? Or is that kind of what you're going with there? Is that

Andrew

11:32

you with 100%? Say that? Yes, that's been the story of Amazon. That's been the story of Tesla. That's been the story of Google Facebook, a lot of those names. Yeah, I guess the problem with it. And, you know, it's something you always have to keep in mind when you're looking at the stock market is, those are the exceptions to the rule. So a lot of stocks that we're not talking about right now, because they haven't gotten to Amazon rival did not find that. So I find Peter Lynch's framework useful because you do want to favor higher growth. And if I were to pick between growth or value in a isolated chamber, you would want you would want growth.

But the problem is, the real answer is somewhere in the middle. And you have to be very, very careful, because it's a slippery slope to say, well, this company has higher growth, so I'm okay paying that price. But over the long term, a lot of companies growth slows a lot. And people don't really account for that. And that's why you get a lot of investing in high growth stocks, that is a bad return for investors because they paid too much.

Dave

12:42

It kind of becomes a, it's like hindsight bias, or, you know, survivorship bias, where you're, you're really looking at, in retrospect, you're in when you look at a company like Amazon and make a comment, like I just made, that's really survivorship bias or hindsight bias, because that happened in the past. And I'm also eliminating all the other companies that may have grown as fast as Amazon did, but didn't have the same

returns, in part, probably because the company didn't reinvest as well as Jeff Bezos did, and produce enough value for customers and shareholders to grow the value of the company. And I love that idea that you're talking about the snowball and how those earnings can build on themselves.

And I think that's such a great visual. And but yeah, you have to balance it out with the price you're paying. And how strong is that growth? Is that going to continue? Is the company have the runway enough to continue to grow for a long period of time? And sometimes they do, and sometimes they don't. And that's investing is hard. And that's why it's hard is because you don't always know and none of us have a crystal ball. And you can't determine that Netflix is going to grow at this rate forever, or Google is going to and I think sometimes we all think that they're going to, but history has shown that that's not always the case. And we've talked about this before. But if you look at the top companies from 20 years ago, they're not the same as they are today, even in that short of a timespan has changed that much. So it goes to show that nothing is forever. And it's that's what makes investing a challenge.

Andrew

14:19

It is a challenge. I mean, one way I think investors can try that. Look past some of that or move past some of that is you can also think about what companies have tended to grow at over the long term. So I looked at like the past 20 years, and what was the earnings per share growth? Because that goes hand in hand with this conversation with PE Right, right. So it was somewhere close to like 789 percent per year was a pretty good average. So if I'm picking a stock with a P E of 20, but it's close to that average, like a percent a year earnings per share growth. That sounds like a Are they good bet I would probably pick that over like a stock with a PE of 15. Only growing at 5%. Right. But where are you get into trouble is when you take the idea too far. And you think, well, this company has grown at 25% for 10 years can do it for the next 10 years. It's like, are they really going to grow three times more than the average? Maybe, but the odds are not in their favor. So that's, I think, how an investor can think about that kind of sliding scale of, of what's reasonable and what's not.

Dave

15:33

Yeah, that's awesome. That's a reference point. I think that's a great way to kind of tie up the whole idea of PE and growth and how people can think about that. And I think that's a good benchmark, to reference when you're thinking about, hey, I really liked this company, but it's growing this is how likely is that to continue? And that's a great question to ask across the board and investing in general is just, is this going to

continue? And whether it's free cash flow, whether it's revenue, whether it's earnings, whether it's ROIC, whatever our favorite metric is,

I think that's a great question to ask. All right, so let's move on to our question. So we have hi guys love the podcast. I'm still new to this, and I've been reading up on the margin of safety. I've run through the DCF model using Wesfarmers Australian company W s, as my example, as I'm quite familiar with the company, I think I've done it correctly. Now I'm just going through the reverse DCF. And trying to figure out which parts of the DCF model Am I plugging in the values, as I imagined some of the figures in the DCF might not apply in the reverse DCF, or some calculations will be reversed. For example, for revenue, no pat reinvestment and free cash flow to the firm, instead of going forward five years, do I reverse the calculations and go backwards?

Or am I way off base? Apologies, I got a bit lost when trying to apply a reverse DCF with my DCF model. Are there any good resources I should be looking at? I am a subscriber to the E letter and have brought a couple of Andrew stocks as a start, and really want to keep learning just stuck at the beginning regard, Josh? So this was a fantastic question. It's not something we've talked about before. So would you like to start off our conversation on Josh's Great question?

Andrew

17:19

Sure. So what's a DCF? A DCF stands for discounted cash flow model. And it is the way to value a stock that is used by most analysts on Wall Street fault, maybe not most, but a lot is a lot. Yeah. So where we are saying P like Davey said earlier, P e is not how to say this is how much a stock is actually worth. And that's a very good way to think about it a DCF is the best attempt at doing that. We look at a business and we see it's spitting out \$2 billion in free cash flow, and we expect it to grow at so many percent for so many years. And so we're going to value a business at you know, 20 billion or something based on those numbers.

And the way you get to that number is through a DCF. The reverse DCF is the idea of it's not doing that going backwards, which is kind of what it sounds like it what it actually is, is you can take a price in the market like Netflix. And if it's trading, I'll even though whether it's trading not these days, sure, if it's like \$120 a share or something, you could use a reverse DCF to basically take whatever Netflix's numbers are whether we're talking about free cash flows or growth, and you throw them into the model. And then you can estimate how much growth Wall Street expects. So that's the thing about DCF models is however, the growth rate is subjective. So the value of the stock is going to change based on what the growth rate you put in this.

So a lot of stocks might be valued at something that's close to their historical growth, which is why you can see that change when management's changed their guidance or they beat or they miss on estimates. And that's why you can see those prices change. So that can be one way that the intrinsic value is estimated for a business is based on what it's done historically. But sometimes it's just like you said, people just get really excited about some sort of the business model. And there could be like, literally no numbers based reasons for the valuation and you see that with a lot of IPO stocks, so it kind of can kind of be varying, but I think with a lot of more. A lot of them are older companies, you can use a reverse DCF to see in general what the markets expecting further growth. Right.

Dave

19:56

Exactly. And it does sound like you put everything in backward doesn't work backwards. But the way I try to think of it is, the only number that we actually absolutely know is a for certain, whenever we look at valuing a company is the price. And everything else is an estimate is what we think reasonably happen, whether it's free cash flow growth, whether it's return on investment, whatever number that we want to assign to the company. None of those are absolutes. But the price is we know what that is. And Michael Mobis, and one of our heroes wrote this great book called expectations investing. And in the book, he talks a lot about DCS and using a reverse DCF to back into the price, and what the expectations that Wall Street analysts and other investors believe, are true about a particular company.

And that's the way I've always kind of tried to look at it as like, it's a backing into the value. And this is what Wall Street thinks is actually going on with the company. And sometimes it can be entertaining sometimes, honestly, to work through a model, and you come up with a price. And you're like, you know, I don't know, they say that the company is trading at \$200. And you come up with a value of \$72. It's fun to just, why is the price, why am I so off, and a lot of times you'll look at it, and it's because the market expects it to grow way more than you do over a long period of time. And that's generally the case. Sometimes there's other finer nuances to all this. And if you can really get into the nitty gritty of this, but the the easiest way that I've done it, it for me is to go forward with the DCF. And do it the way that I would normally do it, put all the inputs in.

And then if I'm coming up with a price that is either above or below the fair value, or whatever it's trading at in the market, then I'll start playing with the numbers to see what the act the market actually thinks. So for example, if you're looking at, you know, insert Company A here, and you think that it's going to grow at 10%, but the market believes it's going to grow at 15%. Sometimes that could be a useful exercise, because

maybe you're being too conservative. And likewise, if it's reversed, if you're coming up with 10%, and the market is actually valuing it at 5% growth, then you can also use that exercise to go Am I wrong?

You know, is it am I being too enthusiastic about the company, because it's very easy for us to get enthusiastic about companies and to get super bullish and super excited and think this is the greatest thing ever. And the DCF for me can help me take those expectations and put it into more realistic numbers. I'll never forget working through Professor Oswald Dhamma Dorans course. And he was talking about some of the examples that he seen. And he had some analysts to be predicting that a company was going to grow at 50% A year from now until the end of eternity. And that's obviously not possible. But those kinds of things they happen. And sometimes we just get caught up in our excitement about a company and we don't think about you know what the ramifications are of a certain thing.

And so reverse DCF is, is a great way to help team, your expectations of accompany. And to look at it. But the easiest, Josh, the easiest way to do it, is just to put all the numbers in just start playing with, you know, generally I only play with one I play with a growth rate of either the free cash flow, or the earnings of the company, I don't mess around with a lot of other stuff. That's generally how I do it. And I find if I just work with one variable, then it gives me a better sense of what's what could be going on with the company. If you start playing around with all the different inputs and variables, it can get really confusing really fast. And you don't remember, did I change this or that or change this. And that could lead to, you know, us, overestimating, you're under estimating a company and either missing or making a bad investment.

Andrew

24:03

I look at it the same way too. It's just like trying to reverse engineer, how did Wall Street come up with their price. And I like your idea, I do the same thing. If I'm ever going through this exercise. Sometimes there can be some liberties you can take when you're looking at the numbers. And sometimes they make sense. So like, as an example, Nike had a pretty bad quarter. And arguably like first half to the year because they had these inventory problems and supply chain and all this.

And so sometimes you might look take the recent numbers and say, well, that doesn't really reflect how Nike has long term because they had these huge stumbles. So you would instead of taking the most recent numbers, you take more of a smooth long term average. So that would be like one way to adjust the numbers. And then you might maybe see okay, that's why Wall Street still has that such at a high price, even though recently, their numbers were so low, that would be one way, obviously changing the growth rate, I think I tend to be a lot more of a stickler with growth rates than most people are. So I can say, all right, Wall

Street thinks they're gonna grow 15%, Soviet, you know, good for them. But at least you can know why it's why it's there.

And sometimes a third thing that you can play with would be like the margins. So a company like Coca Cola, or Pepsi, if they were able to expand margins by this amount over the last 510 years, than Wall Street might expect them to continue to do that the next 10 years. And so you might see that baked into the valuation. And that's why, even with a lower growth rate, it's still coming with a higher intrinsic value. So those would be probably the three things I would look at,

I think Moe person's book is a fantastic resource. I know Mr. De Hearn himself also did a great blog post on reverse DCF on our blog, so that would be another good resource, I would recommend those. And really, it's just practice, I mean, going through and doing enough DCF, I think you finally end up learning it. It's one of those things like, if I were to read it, and I know because I've tried just reading about how to do a DCF equal read about it like a million times, and I don't think it would ever absorb.

But once you actually start getting in there, and if you have a spreadsheet, whether you're using one that we offer, or you create your own, or, you know, you're able to take a class that offers something like that for you, just through that repetition, you start to understand these big terms that we're talking about, and then the numbers start to come together. I think

Dave

26:46

that's exactly right. The more you do, the better, you'll get at it, just like anything else, just a little practice, and you'll start to become much, much better at it. So Josh, great question, keep it up, keep going, you're doing the right thing. And I applaud you for for stepping out on a limb and doing that it's not easy to do. And it can be a little confusing, but you're on the right path. All right, well, with that, we will go ahead and wrap up our conversation for today. If you guys have any questions about anything that we talked about today, please check out our website [e investing for beginners.com](http://einvestingforbeginners.com). And there you will find this fantastic search bar at the top.

And you can research all the different metrics and numbers and terminology that we discussed today. PE ratio growth DCF anything that we discussed today is all going to be available there. There's lots of great articles there that can help you learn more about what we're trying to teach you and it's a great resource for you. So please check it out. And with that, we will go ahead and wrap up our conversation. 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 next week.

Contact sales@advertisecast.com to advertise on Investing for Beginners podcast. The Investing for Beginners podcast is part of the Airwave Media podcast network.

We hope you enjoyed this content. Seven steps to understanding the stock market shows you precisely how to break down the numbers in an engaging and readable way with real-life examples. Get access today@stockmarketpdf.com until next time have a prosperous day. The information contained just for general information and educational purposes. Only it is not intended as a substitute for legal, commercial, and or financial advice from a licensed professional review, our full disclaimer@einvestingforbeginners.com.