IFB257: How to Know When to Take a Loss + Buying Great Companies for a Fair Price

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Dave

0:00

All right, folks, welcome to Investing for Beginners Podcast. Today we have episode 257. We have two fantastic listener questions that we're going to answer today. And so without any further ado, I will go ahead and dive in. And we'll get started. So here we go. Hey, Andrew and Dave. First off, thank you for all the two you do. And for the wonderful podcast and courses you provide. I know you can't give financial advice, but I would love an opinion here. At what percentage do you have to be down on the stock before you bite the bullet and sell taking a loss? I know there could be a lot of other factors are involved here making this a complicated question.

For example, if you're down 20%, and accompany but really, really believe in the future of 10 years down the road, you could always DCA AK dollar cost average into that stock, and lower your average stock price. On the contrary, if you're down 60% on a stock, the odds of coming back from that are slim, when you could move the money elsewhere to make real gains. I hope this makes sense. And I'm hoping you too, could provide a strategy for this. Thank you again for all your help and wisdom. And I hope you to enjoy the holidays. So Andrew, I'm going to turn this over to you first his first week, this is a really good question. And this this could be a lot of fun.

Andrew

1:09

This is a great question. And thanks for writing in, I'm gonna answer from my perspective, which is trying to take a long term approach to investing, which means I tried to find good businesses and try to hold them for the long term, haven't always been that way. But that's the bigger focus lately, even more so than in the

past. So with that in mind, what the stock price has done does not factor in much into what I'm going to do with the stock. Like the listener said, Here, there are a lot of other factors that are involved, which does make it complicated.

But the stock price really shouldn't be one of them, even though Emotionally, it can definitely draw your attention to different stocks. Like if I'm looking at my portfolio, and one of them's way down compared to the other ones, that's gonna grab my attention, I'm gonna take a look. But I might have feelings one way or the other about that, but how I behave, if I sell or not, should come down to something else. And that comes down to the business because I'm buying and I'm investing in these businesses for the long term. So the first thing that I think of if I see a stock that's down is what's going on with the business.

Dave

2:24

Yeah, that's great. And I think looking at the fundamentals of the business, is always probably the first thing you should do, when you see that your stock is down. And we have to remember that the stock market is filled with all kinds of people. And you're going to have people making all kinds of decisions on a daily basis. And your market is going to show up every day and offer us a deal or try to offer us a deal on company A every single day. And sometimes the deals may be great, sometimes the deals may not be so great. And I think one of the things that I try to think about when I see that a stock is down a lot is thinking about what the business model is what my thesis was for buying the company, and has anything really fundamentally changed from that idea.

And if it hasn't, then I then I have decisions to make, then I have you know, like, like they're saying it's complicated. Now I have decisions to make, does that mean that I want to double down on the investment that I have, because it could be potentially selling for lower, and it's giving me more of an opportunity to buy more of the company. And in some cases, that may be the case. And other times it may be that the stock is down for a reason that maybe I haven't discovered. And it may require a little more research or a little more digging in to discover that there's something else going on that I may have missed in my original assessment of the company. And that's always the case. And none of us are perfect. We all make mistakes.

And even the great one more Buffett has it makes mistakes from time to time. And so those are all things to keep in mind. I guess the thing that I struggle with in full disclosure, I own a company called Pay Pal. And it has not done well, since I bought the company. And one of the things that I've been struggling with was whether I hold on to it or whether I double down on it or whether I sell it for a loss. And at this point, I haven't come to a conclusion yet. But it is something that I have been thinking about. And I guess before I kind of throw that back at Andrew, one of the things that I was thinking about along those lines is I remember

reading a few days ago that Charlie Munger was talking about by the way, he turned 99 the other day. So that's kind of nuts. He was talking about in the time that he's been involved with Berkshire I think they've seen I think he said six draw downs of 50% or more of the company's stock, and they never sold a share. And so that's some strong stomach there to handle those kinds of drawdown so it's not unusual to see our company's Wu's stock price fall. Amazon is famous for dropping to what was it five bucks or something like that at some point, and it was down I think 90% At one point, that's a more famous version.

But I like the idea of buffets, because that's a more solid company, if you will. It's a more, I guess, air cooled boring company. And it's not. It's so to see it down that much. And the fact that people have withstood those kinds of drawdowns is encouraging to me. But when I think about Pay Pal, I'm not sure Pay Pal doesn't fall into the same categories as Berkshire Hathaway. So it's a different kind of mindset. So if you had one of your companies in your portfolio that fell 60%, what would you do? Would you stick with it? Would you cut it loose? Or would you possibly buy more?

Andrew

5:38

You're asking me,

Dave

5:39

I'm asking you.

Andrew

5:40

I guess I'm the only one on the other side here. You're

Dave

5:42

the only one here.

Andrew

5:43

So before I answer that, I think, you know, I love the point you make about Berkshire. And one of the things we have to remember, especially when you're talking about the short term or the stock market is it moves, a lot of times that actually moves regardless of what happens inside of a business. So as a long term holder, I'm looking at what's changed in the business. But the stock market's so random sometimes. And I mean, we're going through it now. We're recording this in January 2023.

Sounds weird, say, where the market was down a lot in 2022. And some of that was justified, but maybe some of it was not. And it's just the market can move from so many factors. And so sometimes your stock is down because of something with the business, or sometimes because you were wrong, or sometimes because the markets just down and the entire markets down. So it is important to differentiate that and to remember that there are many reasons why the stock market can go up and down. But over the long term, your stock will go up if the business grows, and you buy that at a good price. So you know, you're asking what I would do if it stocks down 60%. I've had stocks down 60%. So if I just rewind not too long ago, during early 2020, the stock called carnival, which they do cruise ships.

And if you remember, during the pandemic, when that offer started, that was one of the first things to be shut down. So he went from a company with all these great ships that are producing gobs of cash into these big depreciating assets that aren't producing anything. And the business took a huge hit from that, and they had negative earnings. And now all of a sudden, they're burning cash instead of making cash. So I sold that stock, and yet another stock like American eagle, which was down a lot, and I've talked about that company a lot. And I held on to it. And that actually ended up being the right move because it rebounded by a lot and I was able to get out at a good price. So I hope by seeing that dichotomy, you can see that being down 60% can be two completely different scenarios, even though yes, the stocks down 60%. If I was looking at the stock, I mean, I have stocks in my portfolio, I look at Apple today, they're down 10% More than the markets down since I bought it.

So I could look at that and say, Well, that was a mistake. I probably paid too much for it. But at the same time, am I gonna sell it because it's underperforming the market? It comes down to one of those things, where do you cry over spilt milk and compound a mistake and make it worse than it needs to be? You know, one of the bad things about buying the stock when it's too expensive, is you can get a big draw down like this. And then you basically wasted your time. Because if you would have just waited for the expensive stock to come lower, then you could have bought at a better price. But once that mistake has been made that price has been paid, then I feel like the question becomes, do I still want to hold the stock for the long term?

Because the price I pay is the price I pay. But that was in the past moving forward to lock in that cell? That's more of a question in my mind about how do I feel about the company 10 years from now from where the stock price is today. And that's different. It's completely separated from the price I may have paid. So we all make mistakes. We all overpay for stocks. But if you're still right about the company over the long term than the fact that you lost however much in the past because you pay too much that's in the past, like what you do today, like just because you made a mistake in the past doesn't mean you should necessarily sell and change what could have happened in the future, if that makes sense.

Dave

9:41

It does. It totally makes sense. I think one of the things that I try to think of when I think of a company that's down 50 60% visa lost 40% during the pandemic and if you looked at their fundamentals, they did change because of how what happened during the pandemic cross border payments, which is what a big part Have their business dried up because people weren't traveling. And if that continued, that could have been a real hardship for the company. And the point I'm trying to make with that is that you have to think about the fundamentals of the business. And you have to sometimes you have to try to remove the stock price from what's happening with the business, because the price and what the business is doing don't always correlate.

And that's why we can find deals sometimes in the market. And so you have to sometimes you have to focus on what's going on with the business, if revenues are still growing, if they're still operating efficiently, they're still making products that people like, even if the stock price is down, then you know, what, because like Andrew was saying 10 years from now, if the company continues to execute on their game plan, then 10 years from now, they're going to be where you want them to be. And I think that was a great point about what you paid it is in the past, you can't change that.

And what you can change is what you understand about the business, and how that impacts the returns that you're going to get going forward. And if, again, if the company is still executing on a game plan, doing all the things that they need to do to make their customers happy, whoever or whatever they are, then in the long run, you're going to do well with that company, irregardless of where the price is today, whether it's down 60%, or whether it's up 20%, you're still going to do well in 10 years down the road. And that's what I think sometimes gets lost in the emotion of seeing it down 60%, because hey, I have a couple of companies in our portfolio, they're sitting there, it's scary to look at. And I understand that.

But if I look at the fundamentals of the business, and I can see this still doing what they were doing, before the stock price went down, then that helps alleviate some of the problems. Now, if those things have changed, then I'm going to cut bait. If they're not performing, if the revenues are down, they've changed what they're doing, there's something fundamentally different about the business, then I'm going to change and eat it and move on. I think sometimes we get emotionally attached to the investments. And we feel like that we're emotionally indebted to this company. And it can make it hard. It's like we failed, and we didn't fail, we chose poorly. And that happens. And it's best to cut bait and move on when those kinds of things happen.

Because in the long run, you can learn from the mistakes and then you can try not to repeat them the next time. And then as you do that, you become a better and better investor. And we can learn more from companies that don't do well from poor choices and of investments than we can from sometimes, you know, having picking all winners kind of thing. So I think I mean, this is a fantastic question, do you? Is there anything else you wanted to kind of cover in this?

Andrew

12:43

I love that idea. And I'm gonna quote the late and great Kobe Bryant, one of my childhood heroes, and he said, I'm not even gonna call them because I don't remember exactly what he said. But he said something to the effect of there is no failure if you don't quit. So you make a mistake. But if you learn from it, it's not a failure, you'll never fail if you don't quit and you learn from your mistakes. Yep, yep, that's totally

Dave

13:07

right. And I'm so glad you brought that up. As one thing, I want to make sure that people don't take away from this, that if you have companies that are down, or if your portfolio is down 2030 40% for the year, you know, join the club, there was lots and lots of people that were down for the year. And it's not a failure. And the failure would be to quit and walk away. That would be the failure if you quit and walk away because you had a down year. And everybody has a down year everybody, everybody, everybody, everybody, and it's part of the game. And if you quit, then unfortunately, you will fail. But if you stick with it and keep going and doing the things that we've been talking about on the podcast for five plus years, then you will be successful.

And you will do well over a long period of time. You just gotta be patient. And I know that's hard patients does not come easy. And it's not cheap. Very, very true. All right. So I love that Kobe Cole. Thank you for sharing that. All right. Okay, so let's move on to the next question. So we have Hi, Andrew. First off, thank

you, Andy, for all the great content you're putting out there with your podcast website and E letter. I just started investing the beginning of 2022. And you guys have been a massive help in my investing journey. I'm writing to see if you could provide further logic behind this month's pick. I fully understand how a great business it is. But also know that it's not what you would call a great value generically speaking, with a P E of 34, your margin of safety based off your numbers, stated love and point 9% to two and a half percent, which to me isn't too great seeing a higher chance of a negative margin of safety than a positive one. Is this simply a buffet by a wonderful company at a fair price situation? Or is there something to my logic? Typically, I feel like pretty conservative and I don't recall seeing such an estimated negative margin of safety. So I wanted to see if you could provide any further thought not listed in the E letter. So this is a fantastic question and I'm going to turn it over to you Sir Andrew, and we'll Have some fun with it.

Andrew

15:01

Yeah, sounds good. I love this question. Thanks for writing in Giroux. So just to give people background in case they're not subscribed to the leather with every stock pic I do, I estimate what I think the real intrinsic value is. And then there's a margin of safety. So I say, you know, there might be a 10 to 20% margin of safety. In the case of the January pick, it was actually a minus 11.9% to two and a half percent. So essentially, what I was saying is, there's like, you could be overpaying by 10%, or could be fairly valued, or maybe a little bit undervalued.

And, I mean, I guess the easiest way to say it is really buy a wonderful company at a fair price. And you have to be careful, I think, extending that logic out and taking it to the extreme, where you make that as a justification for every stock you buy. But what I'm doing every month is I'm really looking at all the opportunities that I see that are out there. And you know, since I'm not buying the same stock picks six months in a row, in the case that I'm wrong, which I've been wrong in the past, I'm going to continue to be wrong in the future. So you diversify.

But at any given point in time, you look and see what's out there. And sometimes there are more deals, and sometimes you just feel like there aren't that many great deals, and so you buy something that's maybe fairly valued. Versus I would rather do that, if there really is a great company out there. And it's a fair value, I would rather do that, than buy a stock that's super, super cheap. But I only expect it to grow 1% a year, or maybe it's not even gonna grow for the next 10 years.

So you kind of have, it's all about trade offs, when it comes to investing, then you're always looking to see what opportunities are out there. The reality is you can't always control like, I want to buy this kind of a

stock at this price every single month. And so you got to take the deals when they're there. But sometimes you just take what the market has to offer you. And that's how I felt was the case in December leading up to January.

Dave

17:16

So would you bought this company? What percentage of the portfolio is this company now? Like what percentage of it,

Andrew

17:24

it's less than a percent. So it's just the regular monthly deposit.

Dave

17:29

Okay, so the reason why I'm asking you that is sometimes when you're when you're making investments, sometimes the bigger the bed, the maybe the stronger the margin of safety. And because this one has a lower margin of safety, you're taking a smaller flyer on this not flyer, but you're taking a smaller position in his company, and you can grow that position over time as maybe the margin of safety improves or increases. That's a very good point, that's the I will look at it when I'm investing in something that maybe doesn't offer me as much margin of safety as Company B may.

But over time, it could be something that I could build into it as well. And the other thing you have to think about too is when we're thinking about Buffett, there's a great quote, you know, buy a wonderful company at a fair price. Sometimes, there, the market is going to offer us companies that are going to be great investments over a long period of time. But the price that we pay may seem air quote, expensive at the time, but over a 10 year period, it's not going to be and I read something the other day, where people are talking about valuation makes a lot of impact in the short term. But the quality of the business makes a bigger impact over a long term, because it's going to improve the way that the company is operating is going to generate better and better returns over a longer period of time. And it'll lessen the impact of what it was that you paid at that particular time.

And I think one of the things that Charlie was talking about when he kind of talks about this kind of idea, as he talks about the idea of buying a company that has great returns on capital, and over a longer period of

time, you're going to get a great return, I think we'll definitely fall into that category. There's others out there as well. And the other thing about this particular company, if you look at the P E ratio of this particular company over the last 10 to 15 years, it's never been low. Just it's never been cheap. And this is actually the cheapest it's been in a while. And so like Andrew was saying you got to fish where the fish are, and the market presented this opportunity at this time and you got to take advantage of it when you can and if it is a 1% or less position of your portfolio, then it's not a real big bet. And it's also not something that if it doesn't do as well as you hope it does, then it's not really going to impact negatively your portfolio that much and but if it does do well, it has bigger up aside, that would benefit your portfolio much more. So those are things that I think about when I'm thinking about different kinds of investments that I make this particular company I like a lot.

And you know, it doesn't at this time, it doesn't offer a huge margin of safety. But I think the returns on capital are going to outweigh over the longer period of time. And I guess, again, that's kind of the Charlie Munger in me, as opposed to the Warren Buffett and me. So that's, I guess that's kind of my take.

Andrew

20:27

Yeah, I mean, I don't want people to think that, because it's a small percentage of my portfolio that I see it as, like a highly risky stock, like with every stock pic, I'm doing, I'm doing under the assumption that somebody could be building their portfolio for the very first time. And if I think it's gonna be risky for a 10 year period, I'm just not gonna recommend it, period, right. But the numbers back up what you're saying, what Charlie Munger, where you could pay a higher valuation, in the short term, you might have some problems over the long term, it will actually the higher return on capital will balance it out. What makes that so hard is that it's really, really hard to find those companies that actually do that.

So I kind of think of it as think of it as you have like a limited, I don't know why this, like I couldn't get this image out of my head today. But think of it as like, you have a limited number of arrows. And, you know, you're not shooting every arrow at what you think so wonderful company, wonderful company, high valuation, wonderful company, like, these are special arrows that you only pull out at a certain amount of time, because the odds really aren't in your favor when you buy a high company at a high valuation.

But every once in a while, there is that exceptional company. And in the case of this pick, it's one of those that they have a proven model. And they're literally just copy pasting it in different geographies. And I think people like having this assumption about the company, that number of geographies they could copy paste

to are a lot less than there actually is. Right? So it's one of those you gotta have like good reasons why I'm going to spend this arrow on a company that's truly wonderful.

And you know, could still end up being wrong on it. But that's why you invest, because you got to see, sometimes you got to take that chance. And, you know, like a lot of the things you said was some companies that can pay out and we'll see if it does with this one.

Dave

22:29

Yep, I agree. All right. Well, with that, we will go ahead and wrap up our conversation for today. I wanted to thank everybody for sending us those fantastic questions. Those were great. And those were a lot of fun to talk about. And hopefully you guys got some good research and some good ideas from the thoughts that we had. If you're curious about anything that we're talking about, such as P E ratios, returns on capital, any of those kinds of jargony types of questions, please check out our website, the investing for beginners.com. We have a huge search bar at the top of the page, you can simply type in P E ratio or return on capital.

And voila, you will see lots of great articles there helping you learn more about these topics and much, much more. We have over 1000 articles on the website. So if you really want to dive into investing, there's a great place to go. Without any further ado, 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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