IFB261: Mr. Market and Margin of Safety – Our Favorite Mental Models

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Dave

0:00

Alright folks, welcome to Investing for Beginners podcast today we have episode 261. Today, Andrew and I are going to talk about two of our favorite mental models as they pertain to the stock market. We talked about these back in 2017. And they are still our two favorite models, they surround the idea of a margin of safety and Mr. Market.

And we thought we would talk about this a little bit about coming up from an angle of new investors, and how people just getting into the market can use these ideas to help them get started and have success early on. So Andrew, I know you're talking about kind of beginning investors, do you want to kind of start there? And we'll just kind of go through our conversation?

Andrew

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Yeah, sounds good. I guess the first question would be, what's the stock market? And what does it do? So how would you answer at least one of those?

Dave

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Well, I would say that it's not a casino. That's what I thought it was at the beginning, raise your hand out there, all of us, who thought it was casino at the beginning. A stock market to me is a place where we can go buy and sell things.

As we agree on a price between the two of us one will buy from the other and the other will sell to us. And that's what I guess to me, that's what a stock market is. What about you?

Andrew

1:13

Yeah, that's exactly what it is. And what you are buying and selling are basically pieces of a business. And to me, the best thing that you can put on your side that you can take to the bank is the idea that the businesses that are in the economy, most of them will grow over time. So if you invest in the stock market, mostly your investments will grow over time. And it's kind of really that simple. Yeah,

Dave

1:42

it really is. I think people sometimes conflate the market with a video game or a casino, and they see these tickers scrolling across the screen on something like CNBC. And they don't think about the thing, you know, when it says b, k. And that means BlackRock.

And that indicates that you're buying a piece of that company, whether it's Coca Cola, whether it's Microsoft, whether it's apple, and when you invest, I think a lot of people they get away from the idea that that's what you're really doing is you're becoming part business owner of those particular businesses. And like you were saying, they partake in the success or the failure of that business as it goes through its cycle of creating earnings and creating profits and growing. If

Andrew

2:28

that, like other things in life, were just that simple and logical all the time, there'd be a lot less, maybe a lot less excitement, but also a lot less problems. So I guess, because it's a place where you can buy and sell things. It basically is this marketplace, and why the marketplace is filled with human beings.

Human beings are emotional, irrational, selfish, biased, all of these things that we are and that can create an interesting marketplace environment. And I think that's where the Mr. Market concept comes from. So can you explain what that means? Exactly, Mr. Market and where that came from?

Dave

3:08

Yeah. So Ben Graham, in his fantastic book, The Intelligent Investor, he wrote in chapter eight, I believe it is that he wrote about a concept that he calls Mr. Market. And you can call it Mr. Market, you can call him Mrs. Market, it's all the same person. Basically, what that means is he coined that phrase to help illustrate, I guess, the psychotic nature of what happens with the prices that you will see in the market sometimes. And you can see wild fluctuations in price, a lot of times with no reason.

And it seems a little bit manic. And so that's why Ben Graham came up with this concept of Mr. or Mrs. Market. And it helps illustrate how, every day that you now log into our computers, or go on our phone, and look at a stock market app or even just the news, you can see all these different prices changing every single day. And if you follow a company, like let's say Netflix, and you see it's up 5% One day and down 7% The next day, and then it's up 22% In one day and down 20%

The next day, and you think yourself why? That's Mr. Market, Mr. Market is having fun. And the way I like to think of Mr. Market is he comes to me every single day and says, Hey, Dave, I know that you really like Berkshire Hathaway that I'm going to offer to you today for the low low low price of $342. And then I have the choice of going I like that price. I'll buy some or Dude, that's your nuts. That's way too expensive. Go away. And that's what Mr. Market to me is. What about you?

Andrew

4:50

Yeah, yeah, that's a perfect example.

Dave

4:52

Yeah, it's I love it. I think it's an easy way to explain to people, why it's so manic and why you can see such prices Because like you said that at the end of the day, a market is comprised of us human beings. And we can be irrational, psychotic, manic, hoozy, allistic, and depressed people all in the same day. And that's what you see with the prices with a lot of times with no real logical bearing on why the prices move so

Andrew

5:18

much. And, you know, I wonder, you know, being an engineer by trade, obviously, if more logical and rational, right, right, do you think that Alright, maybe I'm more logical, rational, or maybe the people around me are more logical and rational than that. But then if you think about what are some of the big things that move money, like divorce, or, you know, inheritance, or things like that, that can make huge money swings, and you know, people are people and they have money.

So that's where there's just so many, life is complicated, money's complicated. And so the economy is complicated. So all of that mashes together into what we call the stock market. And I like how you brought up the example of Netflix, where, depending on what market and what time period you're talking about, that's exactly what you'll see these prices going crazy. But Netflix itself is still Netflix, I can still go on my smart TV and turn on Netflix and watch it. And it's not like the value of the business, Netflix is changing 20% per day, they're not growing 20%, losing 20% per day.

But because of the Mr. Market, part of the market, that's why you do see that and it does feel like a casino at first. So what is an investor to do to make their investing look more like what we were talking about the beginning, where I'm just trying to participate in the growth of the economy versus being subjected to the swings of Mr. Market? How can investor get past that?

Dave

6:51

Yeah, that's the hard part. And when you're talking about emotions, and we all have them, that's where it becomes a lot more difficult to move past that, the way that I tried to do it is by looking at the fundamentals of the business, focusing on what's actually going on with the company, because we're a business owner, when we buy Netflix, you know, beyond just buying the paying our subscription, when we're an investor in Netflix, we are an owner of that business.

And part of my job as an owner of a business is to understand what the business does, and how they make money, and look at the financials of the business and understand it. Like, if I was the CEO of Netflix, now, I may not be the CEO. But when I own the company, when I own a part of it, I am. And so that's the way that I try to approach it. And by doing that, it helps me filter out a lot of the noise that you will see in the market, because in reality, we only get four glimpses a year of how a company is doing. And those are the three quarterly releases and then with a 10k every year. And those are the really the only chances that we get to find out how the business is performing on a day to day basis.

It doesn't matter that we log in to Netflix and watch squid games or not, that has no bearing on our investment in the business of weather. We can't you know, how many times will be scrolled on Netflix, you can't find anything to watch. Well, that still doesn't really necessarily have anything to do immediately with the business. If that keeps happening over a long period of time. And everybody does, then yes, that could be a problem. But that's a whole other conversation.

But my point with all this is that that's the way that I try to avoid it is by looking at the fundamentals of the business. And by buying it at a price. That makes sense. How do you avoid the ups and downs, the mood swings of Mr. Market?

Andrew

8:47

Now I do all of that. Obviously, as somebody who picks their own stocks and wants to understand these businesses, that's definitely something I do. And the other key part of that is just staying invested for the long term. Because if we think of Mr. Market as giving us a different price every day, he might do that for the next two months, three months, six months. But over the long term, the average of that is going to be close to where Netflix is actually worth, you know whether it's a $100 billion business or $150 billion business, like Mr. Market, even though he is irrational at times, he's not going to come and say,

Hey, do you want to buy Netflix companies is priced at you can buy the whole business for $300. Like that's never gonna happen. It's always somewhere close to where it should be. We're just talking about is it 100 billion today or is it 110 billion today? Sure. I'll take a piece of that. That's what the stock market is. So in any given day, yes. You know, I could be off. I could buy it and be down 5% tomorrow. But if you're holding it for 10 years, which is I think a good starting point. Want to think about how long do I want to own stocks for, if I'm holding it for 10 years, Netflix could grow from 100 billion to 150 billion.

And that would not be a crazy idea, it would not be something way out of historical norms, kind of a thing. And so that's what you do with the different businesses. And so even though in the short term, it's jumpy, it's emotional over the long term, it will be somewhere close to where Netflix the business goes. So obviously, you look for businesses that you think are going to grow into the future, and then try to buy pieces of different ones.

Dave

10:38

I read somewhere recently that one of the real true advantages as individual investors we have is the ability to have a long term horizon. What are your thoughts on that?

Andrew

10:48

Yeah, like I said, I mean, there's only a few things you could take to the bank, and one of them is that the economy is going to grow. If it's not going to grow, we're all in trouble. I'll tell you that. So you can keep an optimistic frame of reference and think about the history, it's been many decades of growth, we think humans will continue to be innovative.

So that and then you combine that with having a long term time horizon. And the odds are just in your favor in that way, to go back to the casino analogy, but it really is the only way to fight against Mr. Market. Because you're betting on the fact that these businesses will be worth more, and that Mr. Market will be somewhere close to some rational for some of the time,

Dave

11:36

some of the time. Yeah, let's move on to the I guess the second mental model that has really stayed true all these years. And that's the margin of safety, you want to start us off talking about margin of safety.

Andrew

11:47

Sure, also a concept from Benjamin Graham, in his book, The Intelligent Investor. Remember, this is a guy who was the mentor to Warren Buffett, he has mentored probably a dozen or more super investors, they call them now, investors who just absolutely destroyed the market, they've done really, really well. And so margin of safety, if you think about designing a bridge, as an example, if you expect an I don't know, I don't design bridges, but maybe you expect 15 cars to be on a bridge at one time.

So you would not design the bridge to carry 15 cars, because there could be you want to leave some margin for error or a margin of safety. So maybe you design it to carry 30 cars instead of 15. So even if you're wrong, and can't carry 15 cars, you're still okay, because you designed for 30 cars. So with the stock market, it's very hard to estimate what we think Netflix, the business is actually worth. And it's very hard because there's so many people who have all their different opinions about Netflix, like I might love Netflix, and you might hate Netflix and and you could talk to 10 people, and they might all have very ideas about the company.

And that can cloud your judgment on how valuable you think a business will be. Not to mention the fact that the numbers for Netflix and its performance, it changes over time, and they might get good at what they do, or they might start to get worse. So it's a very inmotion concept, this idea of what's Netflix really worth is it worth 150 billion, or is it worth 100 billion, it can be fluid, and it can change over time. And it's very hard to estimate. And so what you try to do is you try to buy it, when it's at a price that is so cheap compared to what you think it's worth, that you're gonna win even if he were off by 1020 $30 billion.

So you take that to percentages, but you can apply that to every business. And the idea is, if you're good at estimating what you think a business is worth, and then you pay less than it's worth, and you pay a big enough discount to that, that even if you're off by 10 15%, you'll still make money because you left that margin of safety. That's kind of the whole concept.

Dave

14:04

Yeah, that's a great explanation. And I love the idea of the margin of safety. Because when we are trying to find the values of a company, we are always going to be using estimates the only thing that we ever know for sure, when we're trying to value something, whether it's a toaster, whether it's a car, or whether it's a stock investment is the price. Everything else is an estimate. And so when we're trying to value companies, we're using inputs that we don't know for sure whether they're right or not. And I like to think about when we sent men to the moon, they built in margins of safety into everything that they did.

They doubled up, they had redundancies, they had backups. Those were all margins of safety because when they were building the first rocket ships and space capsules to go to the moon and they didn't know if they're going to work or not. And so they wanted to try to, as best they could build in a margin of safety to ensure that the astronauts came back alive. And when we're investing is obviously not the same importance as sending a man to the moon. But the same ideas is, in effect, we want to try to find companies that are selling less than for what they're worth.

And I think the easiest way to think about that is you want to buy something that's on sale, for whatever reason, whenever we go to the store, we all want to buy our eggs now super expensive, we want to buy them on sale, right. But when we buy companies in the stock market, we don't apply the same rules. And the margin of safety to me is one of those mental models, that helps me try to find companies that are selling for less than what they're worth, so that if my inputs are wrong, that I have a redundancy, and so I don't lose my investment, or I don't make a bad choice.

And a lot of times, it's not going to be that you're making a bad investment, that's going to lose money. And a lot of times, it could be that you're making an investment that won't make as much money as you could have, if you had waited for a company to have a margin of safety. And that's an idea around the opportunity cost lost. Because if you sit in a company that trades sideways, or never really makes, it never does as well in the market as you think it should, over the next five years, that's time loss that you can't get back. And a margin of safety helps ensure that even if the company doesn't do as well, you can still do okay.

And sometimes doing okay is better than not doing well at all or losing money. And there's a lot of factors that go into that. But I guess the basic concept of a margin of safety, to me is finding something that you think is worth $100 and paying $75 for it, or trying to pay $75 for it. And sometimes honestly, you might have to wait. Not every company, that's one of the hard parts about investing.

And the idea of a margin of safety. Is that like Mr. Market is going to come to you every day and offer you this company that you think is worth $100. And sometimes he's going to offer to you for 110. And sometimes he's going to offer to you for 95. And you have to decide whether you want to take that offering or not. And sometimes the 95 is not smart enough of a margin of safety. And if you're wrong on your assessments, then you could not do as well as you could.

But if you wait, sometimes you have to wait six months, sometimes you have to wait several years, there are companies on my watch list that I've been waiting for for quite some time. And I just I haven't been able to pull the trigger on them yet. But someday I will just you have to be patient. And that's part of the investing process.

But the whole idea is built on the idea of having a margin of safety and buying something for less than it's worth. And I love that bridge analogy that to me is like the perfect analogy to help illustrate how important the margin of safety is to investing. And I think it's one of the concepts that if you learn it early on, it'll stick with you and stay with you. And it'll stand you in good stead for a very long period of time.

Andrew

18:09

It is tricky, though, because you are dealing with Mr. Market. And so there have been times I've seen where it's like, wow, there isn't much of a margin of safety anywhere. And then sometimes it's like, whoa, everything. So everything. I can literally buy anything right now. And it has a margin of safety.

So that's just part of the emotions of Mr. Market. And I think having a margin of safety is one good way to try to combat against that. It is hard, and it's the way you apply it really, I think depends on a lot of the things but just to have that framework, you're almost flipping it instead of thinking, How much money can I make? How much money can I make, you're thinking about? How do I make a smart investment, that's not going to wipe me out. And I think doing that's not always natural. But if you can do it, it can save you from a lot of heartache, which when you're talking about money and investing and compounding is the best way to go. Because that's just the way the math works. And that that's the way that stock market returns work over the long term. Yeah,

Dave

19:11

exactly. And I think the other thing, when I think about this idea of margin of safety is it helps you sleep better at night, if you think about the emotional toll that buying companies selling, buying, selling, buying, selling and constantly having movement, all the time in your investments can be very nerve racking and very stressful. And when you're buying a really good company on discount on sale, then you're going to sleep better at night because you're not worrying about that investment. Also, it's only one investment.

Whereas the other idea is you may have five or six or 10 things that you're moving in and out and I gotta sell this tomorrow and I gotta buy this tomorrow. And that can be really hectic. And I'm not saying it can't work for some people and it probably does. But just the way I'm built that's not the way that I would prefer to live my life and you It's also a lot less work when you find, you know, 1020 30 companies that are going to do great for you or do well over a long period of time, then you don't have to do as much work and you jump back and forth on different things.

But I think margin of safety is probably one of the more underrated more probably not talked about enough mental models that I think could be really, really beneficial for investors, and especially for beginning investors.

Andrew

20:24

So me it's kind of funny, I always heard that right. Like, this will help you sleep at night. But when I dip my toe into Options training, I literally did not sleep at night because I would have options I want to buy before the close. And then as soon as the open hit trying to sell them. I literally wake up in the middle of the night because the they have like the post market and the pre market. Right?

Yeah. So it literally can keep you up. And now with cryptocurrency you can literally be up all night. So there is a lot of power in being able to actually sleep at night. And would it be surprising that that actually helps you make better decisions to when you're well rested? I don't know. Crazy, not crazy thought maybe consider it? Yeah, maybe consider it?

Dave

21:05

Well, I think with that, we will go ahead and wrap up our conversation for today. I think this is a great topic to think about these two ideas, especially if you're a brand new beginner or even if you've been investing for a while and you've been struggling, I think these two concepts can really help solidify you and narrow your focus and help you become more successful, which is going to encourage you to continue to keep investing. If you have any questions about anything that we talked about, please check out our website, the investing for beginners.com.

There's a big huge search bar there. And you can learn more about Mr. Market as well as the margin of safety, as well as calculating intrinsic value, as well as all kinds of different fundamental analysis that can help you become a better investor over time. And with that, I will go ahead and wrap up. wrap us up 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.