IFB263: How to Find Compounders + Insider Buying

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Dave

0:00

All right, folks, welcome to investing for beginners Podcast. Today we have episode 263. Today we're going to answer to great listener questions that we got from Nick that I got on Twitter. So FYI, if you guys are looking for a place to reach out to us and send us questions, Twitter is a great place to do it. The DMS are open, and you send me any questions, and we will talk about some of those on the show.

So without any further ado, let's kind of dive into the question. So the first question is, I've been searching for compounding businesses. I'm looking for a strong record of company buybacks. When I look at this chart of target, to me, it looks like most of the compounding was made in the last 10 years.

Does compounding slow down when a company has already brought back the majority of the shares. So this is a great question from Nick. So I guess first maybe, can we kind of unpack I guess, a few of the terminology in there to help explain people, maybe they're new to the show or newer to investing. So let's talk about compounding. First, what are your thoughts on compounding?

Andrew

0:58

Well, Nick, we have something in common. I'm also looking for compounding businesses, businesses that can grow the value on a per share basis.

So if a stock is a part ownership stake of a business, then as the business grows in value, so Well, the stock price, the other way that I can get compounding from a stock a share of stock, is if a company buys back shares, what they're doing is they're increasing that piece of the business that I own, that slice of the pie is becoming bigger for me because they're buying back stock and get basically getting rid of it. And that can create compounding too, because the business could stay the same value. But my stock price would grow because that one share is a piece of a business. And it's a bigger piece when you reduce the number of slices.

Dave

1:49

Yeah, that makes total sense. Okay. So when we're talking about looking for compounding businesses, how do you search for compounding businesses? Like where do you go to look for these kinds of this magic?

Andrew

2:02

They are everywhere around. That's the beauty of it. For me, I like to start with revenue growth. And this is something that I think Brandon's really done a good job of highlighting, is, make sure you're finding businesses that are growing, because that's the easiest way to compound a business that can have profits and grow those profits can sustainably compound and grow in value.

And you can't do that for a long period of time without growing your revenue. So there's a lot of websites you can use, I think stratusphere.io is a pretty good one to get started on as well, Brandon's tool, you can put in the ticker of the company you're looking for. And within the first couple of metrics, if you look at the income statement, you can find the very top line is revenue, or it's also called sales. But that's going to be the very first part of an income statement. And if you see that going up over time, then that's a good first indicator for Hey, this might be a good business that can compound is there a hurdle rate that you look for when you're looking for a compounding business?

Dave

3:09

Like, let's throw numbers there? Let's say that you have a company that's growing at 2% a year and you have another company that's growing at 7% a year, and another one that's growing at 12% a year? Obviously, the 12% is like, ooh, that's great. But obviously, there's going to be sometimes there's going to be compounding, maybe not compounding conflicting issues of why that but why would the 2% one, maybe be one that you'd want to steer away from?

Andrew

3:32

That's pretty obvious, right? Could be Yeah. Look, I get some people have like very strict hurdles, like I gotta have it over 10% or something. And you know, I don't really subscribe to that, because for a myriad of reasons, but I'll give you just a couple of ways to think about it. And what's important about finance and the economy and the stock market is things change. So what was true five years ago might be different today. But we're recording this in 2023.

So there's a couple of numbers, we can think of like a baseline, okay. Inflation historically has been somewhere around two to 3% per year. So in your example, a company growing at 2% revenue per year, is either barely keeping up with inflation, or not keeping up with inflation at all. That's not very good GDP in the United States, which is a measure of how the economy is growing. The economy as a whole has been over the last 25 years. Now, post pandemic, things have accelerated so this data might be old very soon. But let's say the 25 years before the pandemic and the GDP growth around four and a half percent, and I'm talking about not inflation adjusted GDP, just regular old GDP nominal GDP, four and a half percent per year.

So if you see a company that's growing at four and a half percent per year, then that's pretty good. That's growing alongside the economy if it's growing faster than the economy 7% 11% There's two things happening either they are growing faster than their competitors, which means they're taking market share, or their industry is growing faster than the economy, which means they're taking Mart, the industry as a whole is taking market share. You can't have higher growth without either of those things being true. So when I look at a company, I see four and a half percent growth, I kind of don't look at it as favorably today. But I'm not going to completely discount it, because there could be other reasons why it hasn't grown faster than the economy. So I wouldn't want to cripple myself by only looking at high growth names, which means you're just looking only at disruptors.

Dave

5:42

Right, exactly. And one other thing that I think I want to kind of throw out there when you're thinking about compounding and revenue growth, is think about companies and evolution of their lifecycle. And newer, more disruptive, whatever terminology you want to put around it. Newer companies usually will see a higher steeper as my hand goes up, you can't see steeper growth of revenue growth.

And as the company starts to reach more of a maturity, it can plateau, or reach a more, I guess, gradual, yet stable growth rate. And then it can get on the other side of that and start to actually see revenue, either flatten out or start to decline as the company ages. And the products and the services that they produce, start to fall out of favor or other competitors come in and start to take away market share. And if you look at grocery stores or department stores, it's a really easy comparison to see when you look at companies like Sears, JC Penney, any of those kinds of companies that have kind of, you know, reached a high point and became dominant and then have fallen off for whatever reason.

And that's a normal life cycle that most companies go through, you're going to have, you know, exceptions to that rule, always. But as a general rule, you're going to, that's something that you're going to see a lot of now, the I guess the caveat that I like to kind of think about, some of those more stable, or maybe more mature companies that maybe aren't growing as fast, may have a lot of profitability to them. And or they may pay really big dividends. And so when you think about different kinds of investors, some investors are looking for companies in that sphere, if you will, that they want more stable growth, and they want higher dividend payments.

And they don't want to deal with a lot of the volatility that you see from younger companies, as they're growing to that stage. And some people want those really high flying big growth companies and other people want the more stable, I don't think anybody wants anything on the decline. But there may be investors out there that do but that pay really big dividends. And that's really what they're looking for. So it really kind of depends where you are in the pendulum of that growth lifecycle. And when I'm looking at companies, I guess I'm looking for, you know, companies that are, are growing, kind of like what Andrew was saying, you know, above GDP, but it's always going to be on a case by case basis. And I don't necessarily hold myself to a strict you know, it's got to be 12% growth, or when we're done here. It's really all right, yeah, the hurdle rate, I don't like to limit myself by that.

Because there, it's so hard to find great companies that you can grow your wealth in. And sometimes the air quote, boring companies, which we had an episode about, just recently, those can be great investments. And they may not grow at 27% a year, they may only grow at 8% a year. But they also could return you 20% A year for the next one year. So I guess, which would you rather have? Alright, so

Andrew

8:43

let me ask if it's just a matter of volatility. Like if, say, you're an investor, who's young and can stomach a lot of volatility, Then shouldn't you just buy all companies are at the early stage of their growth?

Dave

8:57

That's a great question. And I guess that's kind of hard for me to answer because I'm 56. And so I'm not there. And I don't know, I don't know how to answer that.

Andrew

9:07

So why Yes. And why No, Y Yes.

Dave

9:10

And y no. Okay. So the no part of that equation is probably easier for me to answer. The no part of that equation, I guess, I would think of it as, yes, you're going to experience a lot of volatility, but you're also probably going to experience a higher share price to the value, because investors are always on the search for the new shiny thing. And those companies tend to be the ones that are going to grow fastest and are going to have the highest growth rates.

They're also the ones that are going to attract the most money because they're the new shiny object in the market. And people will get attracted to that. And those typically are the ones that have their prices bid up higher than their actual value is. And so you'll see a lot of these one trick pony kind of companies that come out of nowhere become these huge high fliers. And then when they can't reach profitability, they will fall back to Earth. So that's, I guess the no part of it. The Yes, part of it is, depending on how you structure your investments, you could hit it really big by picking the next Amazon. And that's maybe not the way that I choose to invest.

But there are people out there that have done well, that can do that they buy a basket of 10 of the fastest growing companies in the market. And they understand that they may lose money on eight out of the 10. But they're gambling or betting that two out of those 10 are really going to hit a big and be the next Amazon or the next Google or whoever insert name here. And they can really make a lot of money by doing that. And so that's, I guess, the advantage to investing in companies like that.

That's not the personally the way I like to do it. I can't handle that kind of volatility or guesswork, I guess, is the best way of putting it. But there's certainly a faction of people that do that, and have been very successful at it, and they're fine with volatility.

Andrew

11:02

Yeah, I think that's a perfect way they answer it. Okay. And thanks for making that distinction. Because, you know, it's something that investors should consider when looking at the life cycle curve. And hopefully, we just gave you a good NBA, and investing course, on the course of 10 minutes there. Let's get back to the question, because this is pretty good, after our fun little diversion on compounding. So he's saying, Target has most of its compounding in the last 10 years. And he's saying, Does compounding slow down when the company has already bought back the majority of its shares? I would say,

Dave

11:37

No, the compounding won't slow down when it's bought the majority of its shares. And the reason why I'm saying that is the company has other levers that they can pull to continue to grow. Depending on the business, it could split their shares, they could split their shares, yes, they could easily do that they could they could split their shares, which gives them more shares to buy back over the period of time. It also depends on what industry and what business it is in.

And I guess without limiting myself to a company like Target, they may have, let's think about a company like Amazon, Amazon has figured out a another lever that they can pull to generate more revenue for the company. When the company first began, it was basically a retailer and then and now it's evolved to being a retailer and a cloud company. And some could argue that there's way more value in the cloud than there is in the retail part of the business. But I'm not going to argue that but I guess what I will say is that, because of the optionality of what Jeff Bezos created in the business, he was able to create another revenue stream to allow the business to continue to succeed once maybe the retail part reached more of a mature stage. And again, I'm not saying that that's what's happened.

But that's what really good businesses do is they figure out other levers that they can use to pull to try to generate more revenue. And splitting shares is one idea, but also creating a new business out of what they're doing. And creating it. You know, I think Monique, Bri calls the spawners where they create other businesses within their business. And they use those to generate greater returns over a period of time, Microsoft has done the exact same thing with a juror. So there's lots of examples in the market that they've done that. So what are your thoughts on his question?

Andrew

13:26

Yeah, that's exactly right. They can totally compound in many other ways. And we saw, we've seen lots of businesses do that. We just talked about Texas Instruments. There used to be a big calculators company. I remember when I was in high school, I had the ti 89. And everybody in my class had to have one now calculators makes up one less than 1% of the revenues and yet people still think Texas Instruments calculators. So good businesses are nimble, they evolve, and they know how to do so without blowing up their cash cow, if you will.

And I just wanted to answer the question, literally, it's so I mentioned the split shares thing, just in case just beginners out there. What happens when a company splits their shares is this happened to me when I own a company called Hormel, and this happened like back in 2015 2016. So I had three shares of Hormel and now I have six shares of Hormel. So what they did is they doubled the share count. And if you have for every share, you have you get now two shares. So if you're worried about them kind of running out of this pie, the buyback that can continue just splitting on Google and I think Amazon recently the stock splits Yep.

So unless you think you're gonna own the entire business one day, there's going to be a lot of room for compounding through buybacks because they can keep splitting the shares and people will buy those up. So I don't see it. If a company has had a lot of share reduction in the past that has zero bearing on how much compounding they can have over the future through It's buybacks. I just want to make that super, super clear.

Dave

15:03

Yeah, exactly. To go back to the Texas Instruments example, in the last 18 years, they have bought over 47% of their shares. And they can easily do what Andrew just said, and continue that escalation of buying back shares and turning more and more value to us as shareholders. So there's lots of opportunities for the companies, whether they use the optionality or whether they use the ability to split their shares. So it's a great question, for sure.

All right, let's move on to the next one. So this is also from Nick. He asked, why would the American Express CEO sell the majority of his shares at $178 per share? I guess it was talk about how would he find out they did this? Like where can investors go to learn when insiders which are people that own parts of the company that are management, are selling or buying parts of their shares? Where can they go to find that information?

Andrew

15:53

One website is finviz.com, you can type in a ticker, it's a free website, finviz.com. You type in the ticker, and you scroll down and they have inside their trades. And they will generally tell you what transactions have happened from major insiders, the stratosphere have one two, they do stress for your husband to so stratosphere.io, that's another great one. And you're basically looking for what you know, what's an insider, so CEO, Executive Team, maybe somebody who is like, family of the co founder, and has a lot of shares. So those are kind of like insiders, and most websites should show you like the majority, don't fall into these websites, if they get little details wrong. If you really want to go to the source, you can look at the proxy statement will be one and then there's a particular filing,

I can't form for the form for a lot of those go out. So you could sift through those if you got lots of time. And that's where you can go for that. I guess to answer the question, why would this CEO sell the majority of his shares? Why would like flip the question back to anybody who's asking that? Why do you sell shares? And if you're near retirement, why would you sell shares? Is it to buy a home? Is it to go on vacation? Is it because you're getting divorced? Is it because you want to buy a new car, all of those things could be reasons to sell shares.

And so I know there's a lot of really smart legendary investors who have said, I don't necessarily worry about insider selling. Peter Lynch was one who brought about this in particular, he says, I don't worry about insider selling, because there's a million reasons why somebody could sell but he says he likes insider buying, because there's only one reason they would buy. And that's because they think the price is gonna go up. So that's my answer is I don't know why he did. But it could be a million other reasons.

Dave

17:50

Yeah, I would agree with that. There's a myriad and a myriad of reasons. I love that Peter Lynch idea. And I missed that when I read his stuff. So that's a fantastic insight. And he's, he's 100%. Right?

Andrew

18:01

I think it was Phil Fisher. Fisher, one of the greats,

Dave

18:05

I've read all of their stuff. I missed both of them if it was one or the other. So or I don't recall that. Yeah, I think when people think about insider activity, the I think a lot of people put they try to read into why somebody was selling, you know, the majority. And I guess this is without me understanding what the majority is, is that he sold some shares, or he sold 97.2% of his shares.

And if he sold some of them, that's normal. And you see it all the time, I form fours for visa, for example. And so I see lots of activity, and they just had a CEO change. And the outgoing CEO, sold some of his shares before he left the company. And I didn't read anything nefarious into that, because like Andrew was saying, he may have been buying a boat for his wife, or he may have been paying for college for his kids or something you just don't know.

And so like, I think that quote is a perfect way to kind of think about it. There are 1,000,001 reasons why they would sell, but there's only one reason why they would buy and I think if you see people buying in the company, then that's something to pay attention to. I would get more excited about that. I suppose if you saw the CEO, the CFO, the CEO, and everybody's selling 100% of their shares of the company, then yeah, I would probably be like, Okay, what's going on here? There's something going on, and I need to be aware of it.

But I think when you see a company like this AmEx, American Express, which has been around since the 1880s 1860s, somewhere in that range, I don't think they're going out of business anytime soon. And so the fact that the CEO is selling some shares or even 50% of your shares, we don't know why and for what reason, and there could be a myriad of reasons and I wouldn't get too excited about it, I guess is kind of the way I would take away from it, whether it's an American Express, or whether it's Jeff Bezos, he may be paying for one of his rockets, you know, you don't know. And it's really hard to know, you know, I mean, people were getting super excited about Elon Musk selling a lot of his shares.

But everybody knew what he was doing before he was doing it to buy Twitter. And so there wasn't a lot of ambiguity of wives doing that, I guess, try not to read too much into it and look more for when people are buying because that's the bigger reaction to something. All right. Well, I guess with that, we will go ahead and wrap up our conversation for today. I wanted to thank Nick for sending us those great questions on Twitter. Please keep them coming.

This is a lot of fun for us to talk about these things. And we love trying to help everybody on the podcast. If you have any questions about anything we discussed today, compounding buybacks, any of those kinds of ideas. We have lots of great articles on our website, investing for beginners.com

There is a huge search bar at the top, you can just type in and compounding or you can type in buybacks or share repurchases. And you'll find all kinds of great information concerning those topics and they can help you learn more about anything that we discussed on the show. So without any further ado, 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.