IFB264: Basics of Risk + REITs and DCF

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Dave

0:00

Alright folks, welcome to Investing for Beginners Podcast. Today we have episode 264. Today we thought we would answer one great listener question and we're going to talk about a topic, we're going to go back to a basic and cover a basic in a little bit of detail, and then we'll move on to a little more advanced idea.

So the topic that we're going to start off talking about is we're going to unpack the idea of risk. And what that means in the stock market. It's a terminology that is thrown around a lot. But it really has kind of two different meanings. And it also has two different impacts on how you view your portfolio as well as companies you choose or don't choose. And so we thought this might be a nice, easy way for us to all ease into finance today. So let's talk about risk. So what do you is risk? And how should we define that?

Andrew

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I've felt like I've always heard it, defined by Dave Ramsey as it can feel like a roller coaster, and you only get hurt if you jump off. So the big risk with stocks is losing money. I think when people see their portfolio, and they see a lot of red, and a lot of stocks that have lost money, people feel like they've lost money. But really, the reality is, you haven't actually lost money until you sell the stock.

Really how the stock moves from day to day shouldn't impact you, because the only two points that matter are when you buy and when you sell. And so there has been so much talk, and academic studies about everything in that middle part where the roller coaster is kind of moving around and volatility. But if you really boil it down to the basics, risk is the risk of losing money when you sell after you've bought. And I think that's so easy to lose, because there's so many other complex opinions about risk, and all the other things in the middle.

Dave

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So I guess let's talk about volatility. A lot of people associate that with risk. But I don't think it really is part of the risk. It can be if it causes you don't react a certain way. But you know, what you are talking about? Like, really the only risk is we it goes to zero, that we lose all of our investment or we lose a large portion of our investment. So let's what is volatility? For people who aren't familiar with that term? What does that mean?

Andrew

2:22

And volatility is if you look at the stock and you see it moving, like your heartbeat monitor there, that's volatility. The higher the spikes, the more volatility you have. And so it is tough. I mean, they do there is this kind of underlying idea that the more volatile stock is, the more risky it is. But that's not always necessarily the case. So how would you kind of like differentiate the two? If you saw a volatile stock? Because it could be risky? Or it could in some way? If you're a beginner investor? How do you think of that?

Dave

2:57

That's a really good question. I think the way that I've learned to try to deal with it, when I first started investing, I didn't really understand the difference. And I felt like the volatility was the risk. And it wasn't until I realized that the risk is really more involved with losing money than it is the actual ups and downs on a daily basis. And I think understanding the idea of Mr. Market, and how that mental model works, where someone is going to show up at your door every day and offer you a different price for the company, for PayPal, for example, every day, and you have to choose whether you want to accept or reject to that price. And that, to me is volatility.

And I think Dave Ramsey's idea of the roller coaster, is, I think a really great way to visualize it, because you're still going to enjoy the ride at the end of the ride. But you have to go through a lot of ups and downs through the course of the ride. And it can be depending on you know, if you have a fear of heights like my fiance does, then a roller coaster is a pretty terrifying thing to go through. But if you're like me where you love, the higher the faster, the more upside down it goes, the better, then you enjoy the ride throughout. And I think investing in stocks is the same kind of idea of you know, if you've owned Tesla, over the last several years been through a bit of a roller coaster, and depends on when you get in and when you get out how much you enjoy that ride.

But there's certainly been a lot of ups and downs. And I think as a more experienced investor, I think the way that I try to interpret volatility or looking at it is it's a way of the market telling me they're unsure about the financial or business results that the company is producing, the more stable the company is producing, the more stable the results are going to be in the market.

When you see a lot of volatility in the financial results of the company. You also will see a lot of volatility in the market related to that company as well. And it can also depend on have, you know, flamboyant CEOs, ie Elon Musk can cause a little bit of volatility along the way as well. But I think that's the way I tried to think about it, how about you,

Andrew

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I think that's a great way to do it, I would try to separate it kind of like you're saying separate what's happening with the stock ticker, and look at the underlying business. So I'll give you an example, like the steel industry, steel has been around for a long, long time, if you're producing steel, there's not much way to differentiate yourself, my Steel's not gonna be any different from Dave steel, it's a commodity, it's interchangeable. So when you have a commodity like that, and there's no differentiation between what me and Dave are producing, than the price of steel is completely supply and demand.

And so the problem, when you get into these products that take a long time to make like steel, is you can have these big ups and downs, in the steel market, the price of steel can go up and down a lot. So the companies that are producing this will see their earnings go up and down a lot. So that to me, that's a case where Yeah, actually, if the stock price is just following their earnings going up and down these huge swings, because it's a commodity type business, to me, that is risk, that's the volatility matching the risk.

But if I have like a great business like Microsoft or something, it's almost like you can take it to the bank, that they're gonna increase their revenue every year, if their stock price is swinging, because one day they were popular in the next, you know, the next six months, they're not, that doesn't mean that Microsoft as an investment is risky, because you can look at the business versus the stock price. And so that's the big place I try to go. Because I try to avoid more volatile businesses. So I do that by looking at profits instead of looking at the stock price. And I think that can be a good place to start. Yep,

Dave

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I totally agree. The stock price is the one thing that we know for sure, when we're looking at investing in companies. But I think that idea that you mentioned at the beginning, where you talked about focusing on the fundamentals of the business, and not the ticker, in the market, I think is a great thing to help separate the volatility from the potential risk of the investment. Because when we buy stocks, we're buying a piece of that business. And the ticker is is a representative of what the market thinks the company is worth or not each and every day, but the business that we buy has, the profitability of the company is only going to be determined every 90 days.

And so we're not going to see that today. They had great sales. And tomorrow, they have great sales, but maybe on Thursday and Friday, they don't have great we, we don't see it broken down in that microcosm, we only see it in a 90 day basis, at best. And so I think that helps me smooth out some of the volatility because I can really only look and see what happened yesterday, from what the company tells me their last 90 days of results were and I can only base my future on what I think they're going to do in the future. And it doesn't matter what it does next Thursday, to, you know, the overlying underlying stock price in the market.

That's I guess, a separate issue to me. And that's I guess how I help ground myself is that what I can control is what the company does one of the companies that I follow, Arjun, which is a Dutch payments company, they only report results every six months. So you can see wild volatility in the company, but it's based on the market, not the actual financial results of the business, because those only come out every six months. And so you sometimes you look at and go, Why the heck is the company down 12% Today, what happened? Literally, there's nothing that happens.

But there's other market forces that make the company move. But that to me is not the risk of investing in the company. The risk to me is more involved what they do every six months, as opposed to what happens on Tuesday.

Andrew

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It's a great point, as you were talking, I realize I completely misspoke, because literally just last quarter, Microsoft missed on revenue. I tried to think of everything with investing kind of on the spectrum. And so if

Odgen or Microsoft had one bad quarter or one bad year, that's a lot different than a steel company who has crazy swings every year.

Right? Like you have to understand, yeah, there's going to be some maybe weaknesses in the business or a little bit of volatility. But that's a big difference between, hey, we five times their profit this year versus, you know, a more stable business that might see a lot less fluctuation in their profit. I hope that's helpful just to kind of think of it in broader terms rather than ooh, this company's risky because they stumbled last year or not.

Dave

9:48

Yeah, I think it is. I think helping define the term risk and understanding the different components of it, and how it can affect your investing, I think is important for investors to undertake And because it can impact whether you stay in the market or whether you get out of the market. And I think once people understand that the business results matter in the long run, as opposed to the volatility of the stock price, I think that will help stabilize people when they think about their investments long term, because that's the biggest advantage we as individuals have is a longer term horizon.

And we can be patient, we can sit on our hands and not do anything and let the company do all the heavy lifting. And over time, the company will perform. And hopefully, if we've done our job, right, the company will perform and do a good job for us investing wise.

Andrew

10:34

So what are some practical ways that an investor can mitigate the risk?

Dave

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Well, I think the first one, I think is pretty obvious, is figuring out how to buy the company with a margin of safety building in a risk load. And we talked about this, when we were talking about margin of safety a few weeks ago, about building a bridge that can handle you know, up to 30,000 pounds of force of a truck, and then only driving 10,000 pound trucks over the bridge, and not pushing it to the 30,000.

So I think by understanding buying the company for less than what it's worth, gives you a margin of error, in case you're wrong. And I think that helps avoid risky investments. So I think that's I guess the first one will be some ones you would think of

Andrew

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diversification comes to mind. So just this idea that instead of putting all your eggs in one basket, you put them in several baskets. And so that can be very helpful. As an example, if you were 100%, and restaurant stocks in 2019, you could have had the best restaurant businesses in your portfolio, and it wouldn't have mattered. So you can argue that that doesn't matter now, because they've all recovered. But the reality is there have been industries of, you know, basically completely, otherwise, like disappear, but have had really, really tough periods, airlines being another one. So you just don't know what's around the corner. And so to me, by having a lot of different businesses who reduce that risk a lot, because we don't know what the future holds.

Dave

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Yeah, I think that's a great idea. And depending on your tolerance and your stomach, I think one thing that you could do to help reduce the impacts of volatility is to not look at your portfolio that much. There are some people out there that believe that you should only check your portfolio every quarter or every six months or even once a year. And to help reduce the access to information that we all have.

Now, sometimes it can be really easy to look every single day or sometimes multiple times a day, to see how your portfolio is doing. By doing that you could react to volatility in a negative way by seeing something down and oh my gosh, I gotta get out of this, because it's a terrible company. And it may not be a terrible company, it could just be that the market is all down that day, or is having a down period. And those are things that can certainly impact your mental state of mind. And there are some people out there that believe that by not looking at their portfolio on a regular basis, it helps counteract that reaction to volatility.

Andrew

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So my question to those people would be, how do you add new stocks? You just memorize memorizing the buy buttons here? I agree that looking at your portfolio less definitely helps with dealing with volatility. That's no question.

Dave

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Yeah, yeah, I personally go through fits and phases. Like, I'll have periods where I literally won't look at my portfolio for probably weeks. And then I'll have other periods where I'll look at it over like every single day. And it doesn't impact me one way or the other. But I just have noticed that the more I'm longer I'm doing this, the less interested I am in watching it every day. And I'm more interested in learning about the companies and staying focused on that, because I can't control what happens to adjourn today versus tomorrow.

That's beyond my control. All right, so let's move on, I guess to a little more advanced idea. Before we dive into this, if there are any terminology, or factoids, or metrics that maybe we discuss in this next section that you're unfamiliar with, please check out our website investing for beginners.com. We have a ton of articles that are going to relate to this topic that we're going to talk about. And there's lots of great resources there that can help you define some of these things. If you're not super familiar with it, we will try to break down as much as we can.

But for those that are really beginners, some of this may be a little bit overwhelming. So I wanted to give you just a bit of a heads up. So here's the question we had. It's a great one. So I'm a longtime listener and appreciate all your guys teachings. The last episode on spin offs was awesome. I have used the website a lot as well to further my understanding on topics and get into the nitty gritty. I was recently digging into REITs and going through the postings on FFL Oh HFO nav for REITs. And it was a little unclear to me how you guys perform a DCF on REITs. I get the SFO and fo are the earnings part. But do you still use a sales to capital ratio? Do you include taxes at all? Do you subtract debt? I realized this may be too complex to cover on the podcast. Nope, it's not. But thought it might provide a good write up topic.

Going through a specific example. I once again want to express my gratitude to you guys, I started off knowing nothing about the stock market. And your podcast, a website has really taught me so much. And this is all from set. So thank you, Seth, for that great question. And we appreciate the kind comments. It's a great question. So Andrew, let's start off and talk about what are REITs like for people that are not for what is a REIT? What is that? Oh, man,

Andrew

15:42

DCF Rei T FF

Dave

15:47

acronym city.

Andrew

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So rate stands for real estate investment trust. And the simplest way to think about it is it's a company that's buying up real estate. So you could go down to your local place, wherever there's a few stores, like I'm thinking of, like Dick's Sporting Goods, and like bed bath and beyond what's left of it Dollar Tree, like Petco like this AMC, AMC, right, like a commercial real estate area, that's generally owned by a REIT. I mean, there's individuals to and you know, but a lot of REITs will own those. And basically, what they're doing is they're almost like crowdfunding their real estate business. So they are distributing pieces of their business in order to buy real estate, or they're issuing debt in order to buy real estate.

And so if you own this ri you own part of their real estate portfolio, understanding that they're going to continue to try to buy more real estate. And then as that real estate, as the tenants like Petco and Dick's Sporting Goods and Dollar Tree, as those tenants pay the landlords, then part of that rent goes back to the REIT owners as a dividend. That's how I would try to describe it to somebody who's never heard of it.

Dave

17:04

I think that's a great description. The REIT industry is a big industry. And there's lots of different flavors of REITs that you could invest in. So Andrew was talking about commercial real estate, there's also real estate, you could buy land, you can buy forests, you can buy REITs, that buy health centers, yeah, data centers, health centers, apartment complexes, there's just about every sector of real estate you can think of, there's a REIT that covers it.

And so it gives you the opportunity, the thing I like about REITs is it gives an investor the opportunity to have real estate in their portfolio without having to go out and gather up the capital to go buy a building to you know, be involved in a real estate business. Now, there's other aspects of the real estate business. And I'm just generalizing. So, you know, kind of keep that in mind, if you're just an average investor, and you would like to have a slice of diversification by having some real estate or REIT is a real easy way to kind of dip your toes into that. Now one of the struggles with investing within REITs is that they have a lot of acronyms. And the terminology is a little different than it is if you're going to buy a company like Microsoft or Google.

And that's where kind of understanding the language of REITs can really help you get a better sense of how to value the company's how to understand the business models, and everything. So I guess Can we talk a little bit about FFL, and AFL maybe from like a 30,000 foot view, so people can understand a little bit about, you know, trying to, I guess, decode a couple more acronyms for everybody.

Andrew

18:36

Yeah, there are things that make the profit and loss statement of a REIT, a little more muddy. So depreciation, for example, I think we can kind of understand what depreciation means.

And so that has a big impact on how a REITs profit and loss statement looks like. And so they have other metrics like FF O, which stands for funds from operations, what they're trying to do is they're just trying to strip out all of the other stuff. The other thing that really muddies up their income statement is that they're probably a lot of them are buying and selling a lot of properties. So they're like, selling the underperforming ones buying what they think are better ones that really makes the income statement messy to so I might look at 2022 and have no idea how the properties under this array are doing.

Because they've been flipping so many properties. I don't know what the core portfolio is doing. nffo tries to tell you what that is, because it gives you basically the cash flows that are coming from that core portfolio of properties and reporting that and that's a place that a lot of investors who are interested in REITs will start with is F fo and then AF fo is just an extension of that, where if I had a building and I was leasing to Petco and if me as the landlord was responsible for maintaining that building, then I would have to make it capital investments in order to make sure that the building's still gonna stand in five years. And so that might be an ongoing process with a lot of different properties. So a FF o includes a lot of those investments that some of these landlords have to make. And so if you think of that as a parallel to the investing, like regular kind of business world we're more familiar with afff starts to sound a lot like free cash flow.

Because a company does that to Ford needs to make new Evie vehicles, they're going to build up a new plant in order to make the new Evie vehicles, that's capex, and then whatever's leftover is free cash flow. So it's the same thing with FFL. And nffo. FFL is trying to tell you what the cash flow is after they have invested in the buildings, the long term assets. And FFL is just trying to tell you how the core portfolio is doing before they're maintaining the properties.

Dave

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I think that's a great way to look at it. And I guess one of the things that people may get a little overwhelmed by those terminologies and some of those ideas, and may think they may be sitting there thinking how in the heck am I supposed to figure out how to calculate those, and most REITs will lay that out for you in their financial statements. So if you're reading their 10k, or their their quarterly reports, they will list those that information out for you. So you can use our friend Ctrl F, and just type in funds from operations or FF, Bo, and you'll find where they actually delineate in their statements, what their funds from operations are.

So you don't have to go through the hassle of trying to figure out a calculator and learn all the ins and outs of the terminology, it's a good idea to understand the line items and how they impact the number that's going in there. But as far as like having to actually dig through the statements to try to find the information, the REITs will do that work for you. So it'll help make that kind of whole idea, I guess, a lot easier to understand. And so I guess, having that kind of information, then do we want to unpack maybe the idea of a DCF with a REIT. And maybe how we would kind of approach that to help Seth and anybody else is interested in trying to value these companies.

Andrew

22:21

I believe this will be the last acronym today, but

Dave

22:26

DCF stands for discounted cash flow. And it's a valuation model where you're trying to determine the intrinsic value of an asset. So for this rate, we're trying to figure out what should the price be in the stock market for this REIT? That's a DCF. There are several ways to calculate DCF, which can make it complicated. He mentioned the sales to capital ratio, which is more the way you traditionally do DCF. So you want to give like a brief overview of that, and whether you would use that for a REIT?

Yep, so a sales to capital ratio is an idea that Professor Oswald de motoring came up with, that is a good way to measure the impact of investments that a business makes to grow. And so the basic gist of it is you take the capital that a company has, and you measure the difference between year to year and you measure that against the growth in sales. And that's a ratio that you can use to help you project how much efficiency and how much sales, they'll generate every single year, from the capital in the business in to, I guess back up to a little higher level of understanding.

When we're talking about capital, we're really talking about the assets the business uses to grow every single year. And every company has different assets that they use, the assets that Microsoft has, are different than the assets that Walmart has. And so they use but they still use their the assets, they have to grow their business every single year. And we're trying to measure that.

And the sales to capital ratio is a is an easy way to do that and incorporate that into measuring that against the cash flows of a business. And traditionally, it's used typically the way I use it. And the way I've seen it used is using it in more I'm going to use air quotes, air quotes, traditional businesses, so companies like Walmart, Microsoft, Google, Amazon, Tesla, PayPal, Visa, any of those kinds of companies that the income statements, the balance sheets, the cash flow statements all kind of lead you to a path to value the whole business. It's an easy way to value the whole business by using a sales to capital ratio, or REITs.

Alongside banks and insurance companies are kind of different beasts, and because they use debt in a different way Then Walmart does, you have to value those companies in a different way. And so a sales to capital ratio well, great for helping measure the investments for Microsoft, it doesn't work so great for digital Realty trust. And so I wouldn't use that kind of ratio for a REIT. And I guess that's kind of how I would I guess, organize that idea moving past that, I guess, how would you look at trying to value a REIT, when I'm

Andrew

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valuing a company, I'm primarily looking at the cash flow statement. And then you do the same thing that they've talked about where you want to figure out how much is the company reinvesting to grow. And you can also find that in the cash flow statement, you just have to be careful that you are looking at a long term view of that not just what happened last year, because capital long term investments, these big capital investments, like a new building, might hurt a lot in one year, take the money and then it pays off over multiple years, you want to kind of factor that in for multiple years, in a sense of a REIT, you can just in the same way, you would take a cash flow statement, to find out a company's free cash flow for the long term.

And use that for evaluation, you can do the same thing with their AF fo, that's the way I would look at it, you just substitute free cash flow per share for FF o per share. And since I'm not looking at the balance sheet, or the capital stack, you know, I'm not, I'm not looking at a firm, I'm just looking at the cash flow statement, you're able to do that.

Dave

26:34

Yep, that's exactly the way that I would do it as well. It's the one thing that I always try to tell people when you're looking at valuing companies irregardless of the model or the method that you're doing, try not to get bogged down in the minutiae, and trying to create super complex models with lots of moving parts for and keep this idea or mental model in mind, you're looking for an approximation of value, not the precise price of entry. A lot of people sometimes especially new people to investing, get bogged down in the minutia, and they want to find out that I can buy this particular read at $45.27. That's not material, it's better to find a range of values that you think are going to be appropriate, and then kind of trying to figure out how likely those are.

Whereas as opposed to trying to define the the finite price because it doesn't exist. And Warren Buffett is not successful, because he bought apple at $84.19 A share it that doesn't have any bearing on how well he's done in his investment in apple. And it's good to find it at a price of less than what it's selling for, we all want a sale, we all want a deal. But don't get bogged down in the minutiae and also give you this warning of not having a super complex, lots of moving parts, kinds of DCF models or models, just in general, because the more inputs you have, the more margin of error you're going to have.

The more you the more moving parts you add to something like that, the more chance there is you're going to make a mistake, and that could throw off the valuation. And one of the things that I love about Professor Demeter in is that his models are as complex as they need to be and not one iota more. And a lot of times he tries to make things as simple as he possibly can. And you got to remember, this is a very smart man who's been teaching valuation for 3040 years. And he really knows his stuff in and out. And he tries really hard to make everything as simple as he possibly can, to help make sure that we don't make mistakes.

Because the more input you got, the more chance there is to make a mistake. And, and that's what I try to do as well. And I know Andrew does as well. So if you take a warning away from anything we're talking about, please, always try to keep those kinds of ideas in mind. So you don't get bogged down into minutiae and having super complex models. Well, with that, everyone, we will go ahead and wrap up our conversation for today. I wanted to thank Sef, for sending us that fantastic question.

That was a great question. And please keep sending these fantastic questions, guys, you guys asked really, really insightful, great questions and really make Android I think, and stretch. And it's a lot of fun for us to talk about all these things. And again, if there's any terminology that we discussed later in the show, or even earlier in the show, please check out our website e investing for beginners.com

Very big search bar at the top of the page, you type in a CFO or you can even type in risk. And you'll find out lots of great questions, or lots of great articles. There's over 1300 articles now on there. So there's plenty of opportunity for you to find something to learn on the website. And it's resource there exactly for that to help you earn the great art of investing. So without any further ado, I'll 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.