IFB266: Where Does the Money Go After Investing + Buying Companies Going Up

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Dave

0:00

Alright folks, welcome to Investing for Beginners Podcast. Today we have episode 266. We have three great listener questions that we're going to go ahead and read and answer today. So without any further ado, I'll go ahead and dive in. And we'll jump into the first one. So we have, Hi, Andrew and Dave, as a beginner, I have a core stock question, which would be nice to get more detail on.

When you buy a stock? Where does your money go? How does it travel through the system and into the hands of the company to invest with your money? When a stock price falls? Where does that money disappear to? Thanks for your great podcast? Chris from the UK? So this is a great question. And this is not something we tackled before. So Andrew, I guess, do you want to start with? Like, where does the money go? When we invest in a company? Like how does this money flow from point A to point B kind of thing?

Andrew

0:47

It's an excellent question. And in explaining the basics of the stock market, I think sometimes something gets miscommunicated. So we'll try to do that. There's two different ways that stocks are bought and sold. They've we discussed this before the air, there's the primary IPO, and then the secondary market, right. So the IPO is something where you know, if Dave and I have a lemonade business, and we wanted to scale it up, and we wanted it to be the biggest lemonade business in the world, we would divvy out lots of pieces of our business to raise capital.

And so the people investing in our lemonade business would be giving us the capital, and that's going directly into the business to grow the business. So that's exactly what happens with a stock in an IPO situation. Yeah, the company like Airbnb went IPO a few years ago. I'm sure a lot of that money that they got from the IPO, went back into the company for marketing, and establishing technology to help them grow over the long term. However, when a company is not IPO anymore, and if they're not actively issuing more shares. If it's a company like Microsoft, who hasn't had to issue shares in a very long time, these more mature companies, when you buy their stock, your money is not actually directly going to the company. It's actually just changing hands between other people. So do you want to kind of explain that part? Dave?

Dave

2:18

Yeah, so the stock market is, basically, it's made up of two groups of people, it's made up of people that are buying companies and people that are selling companies, and the money exchanges hands based on the different prices and when this company is bought, and then when that one is sold, and that kind of thing. So a stock market is just basically a group of people that are buying, selling, buying and selling a piece of a company based on an agreed price of the company.

And so like Andrew said, there is an IPO and then there's a secondary market, the majority of what we talk about when we're buying and selling stocks, happens on the secondary market. And that's when we think of Wall Street, we're actually thinking of, mostly we're thinking of the secondary market. But the capital that's contained inside the secondary market doesn't actually leave, it's just trading hands between who's buying and who's selling the company. And so I guess that's kind of the basic gist of it. So that money in a secondary market, again, does not go to Microsoft or Google directly.

Andrew

3:22

So if I'm selling my shares on Microsoft, and Dave's on their site, buying them, Dave's giving me cash, and I'm giving them my shares, Microsoft never touches it, right. And there's brokers in between. So those are like Fidelity or Schwab. They're facilitating these things, but essentially, that's what's happening,

Dave

3:40

right. And so the money

Andrew

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actually stays in the brokerage account until there's an exchange of ownership, I guess, of the company. So I guess let's talk a little bit about like when the stock price falls. So what happens to the money when that when we see that on our side of the trade, I was trying to think of how the kind of simplify I would just think of if you owned a home, and let's say you bought the home for 300,000.

And then let's say a week later homes that are comparable to yours are trading 400,000 500,000. If your home had a brokerage account, it might say that your home is now worth 400,000 or 500,000. But that's not money to you unless you actually sold that 400,000 or 500,000. So on the flip side, if you bought a home for 300, and then the homes around, you're selling for 250. It's not like the money disappeared because the value of your home went down necessarily.

It only disappears when you sell. So I think something they say a lot in the financial media is you know, Mark Zuckerberg lost $66 billion dollars today in value from Facebook stock and they wiped out like that's yeah, the value of a stock went down and on paper, maybe the value went down but nobody actually lost is money in the tangible sense of losing dollars? There was more of these things, and then they're on paper, but you don't actually lose the money until you sell? Right? Yep,

Dave

5:09

I think the House is a great example. I think that's the, for me visually, I think that's the easiest way to think about how the change in value doesn't really isn't realized until you actually do a transaction until you actually sell it or buy the property. And I think that's probably the easiest way to think about it with your stocks.

Because the value of Microsoft, it'll change, but your ownership doesn't change until you actually do a transaction. So even though you may see that the stock, the price of Microsoft has fallen $30, since you bought it, that doesn't mean that $30 has disappeared from your account. That doesn't happen until you sell it at a loss and then that money does, you'll see less money in your account. But until that actually happens, it's not realized. I think that's probably the easiest way for me to think about it. I think your house is a great analogy. Alright, so let's move on to the next question.

By the way, Chris, that was a great question as something we hadn't really talked about before. And I think it's an important subject for people to understand. So Alright, so let's move on to the next one. We have Hello, Andrew and Dave, I have a question. But I want to first say how much I enjoy the show. I eat, sleep and breathe this stuff. And I love how you guys aren't wacky and try too hard with jokes, fluff and filler. Like some of the other shows I've tried. Just to the point with great information in real life honest experiences. I have a long commute. So it's like driving with two good friends to answer questions I've been thinking about. I have some great companies that are under green, even though these are rough times.

My problem is that I find it next to impossible to buy more shares when the share price exceeds my cost basis. I only buy more shares when the prices are even are far below. So I'm currently sitting on cash. These are all solid dividend payers. So I know having the long term compounding in income is a smart thing to do. I'm sure my method is wrong. So I'd appreciate your perspective, not wanting my cost basis to increase. Thanks, guys for taking the time to do what you do, Mike. So Mike, thank you. There's a great question. I'm gonna throw it to Sir Andrew. And we'll kind of start unpacking this a little bit? It's a very interesting question.

Andrew

7:14

It's tough to answer because it's very easy to get caught up in this mindset. And so Mike, I wouldn't call your method wrong, necessarily, I feel like it's a very logical way to think about it. Because I think our brains are hardwired to, at least for me, it's like every day, I want to be making progress towards something.

So if you're buying a stock at a higher price than when you bought it yesterday, you don't feel like you're necessarily making progress. And I can see how you feel like you're making progress if you buy when the stock goes down. So that totally makes sense. And there's all sorts of, you know, psychology that goes along with that. And there's plenty of studies, I'm sure, I guess the problem with that is investing is more about kind of like what we were talking about in the first question, you're buying ownership in a business. So what happens with the prices, especially in the short term, is doesn't always reflect what the actual business is.

So I know like a business like Microsoft wouldn't necessarily become so much more valuable in like two or three days. But, you know, let's say six months from now, a company like Microsoft, let's say, as an example, greatly improved their search engine, Bing. And now it's all of a sudden getting a lot of users just from that perspective alone, Microsoft might be more valuable now, because it has more users on this platform. But if you're anchored in this idea, well, I bought the stock at 285.

And so now it's at 290. So I'm not gonna buy any more, that might not reflect the fact that it's more valuable six months down the line. So it might actually be worth now 300, from the business perspective, because of whatever they've done inside the business, and might actually be even a better deal at 300, then that was at 285 as investors and that's the hard thing that we have to do every day, it's the hard work, you have to separate what you see in your brokerage account, or what you see is your cost basis. And you have to separate that between how it actually relates with how businesses are doing. And that could be a whole conversation on its own. But that's kind of the mindset you need to take when you're thinking about what am I going to do from an ad to a stock or takeaway from it.

Dave

9:39

So can we go back for just a second and maybe explain what cost basis is kind of a, I guess, an important term here and the question and there might be some people out there that aren't familiar with what we're talking about, what is this magic you're talking about?

Andrew

9:52

It's yeah, that's a great point. We should definitely cover it cost basis would be the price that you purchase the stock at. So If we were going to buy Microsoft stock at 285, our cost basis is 285. And this is important because when you sell one day, if you're going to be taxed by the IRS on your cell, they're going to look at what was the price you paid? And then what did you sell at the price you pay, that's the cost basis.

And that's how they calculate it. Now, something that can be beneficial for investors is, let's say Microsoft went from 285 to 250. Well, if you were to buy more at 250, you bought some at 250, you bought some at 285, your cost basis is now somewhere in the middle of those two numbers. And so you can lower your cost basis by buying more when a stock is down. And so over the long term that makes your gains bigger, because 10 years from now, if Microsoft set 400. You know, your cost basis is now let's say 270 instead of 285. Because you bought more when the stock was down.

Dave

11:01

Yeah, that makes sense. Yeah, totally. You would add, I guess to that, I think the cost basis is it's a great idea. And it's something that's very important to think about, because it goes to the returns that you get, it also goes to our I guess our mindset of what we're thinking about how this company is doing, versus what's going on in the stock market.

And I guess, you know, Mike, the couple of things that I guess I tried to think about is, number one is the value of the company, what is that at that particular time that you're thinking about possibly re buying the company or looking at buying it again, because like Andrew was talking about, it's not just numbers, we're also talking about a business that's operating on a daily basis and trying to create value for the company as well as its shareholders. And if Microsoft is generating more value six months, a year from now, then it's also logical to assume that the company is more valuable now than it was. And so one of the hardest things for me, and this is something I struggle with, I freely admit, is averaging up, as opposed to averaging down averaging down to me seems like it's super easy, no brainer thing to do.

But averaging up is for me is harder. But one of the things that I try to think about is the value of visa more valuable now than when I bought it a few years ago. And if it is, then it makes sense for me to invest in it again, even though it's at a higher cost basis. And because the value of that company is going to continue to compound over time, and I'm still going to earn a great return on that investment.

And I guess the other thing to think about, too is, do we want to quibble about a $10 increase in price over the next 20 years. No, not really, I mean, you know, in the grand scheme of things is that the latte and a croissant at Starbucks really worth all the stress and agony, the you know, 20 years from now, none of us will remember that. But I think trying to, I guess, think about what our goals are with the investing and what our goals are with this particular company and in thinking about what it's worth, now versus what it's going to be worth in 1015 20 years. And if the company is improving their performance, then logically, it's going to be more valuable. And so therefore justifies us paying more for it now versus when we first bought it.

But, you know, having said all that, it's logical and makes sense. But it is psychologically, it's harder for me to buy up than it is for me to buy down. And it's something I struggle with too. But I just tried to think about the valuation part of it, or the price, the value versus what I'm buying. And if that's still in a good relationship, I think it's kind of I think it's easy to just buy that let's, you know, he's talking about solid dividend payers.

So let's say Johnson and Johnson, just for example, if that company is performing really well, on a business level, then Johnson and Johnson is going to be more valuable. So it would make more sense to buy more of it, even though it's a higher cost basis. So I guess that's my kind of

Andrew

14:06

thought, it is so hard. But if you think about it, what makes the stock market go up? You know, what's going to make a stock go up when a company does better than people expect? So that's a good thing, right? So a lot of times it is for good reason why a stock might move, and you have to get over that psychological hump.

And that really hurts if you're calculating cost basis and return because when you average up, I can almost like slice your return in half. Right? And I see that and that hurts in the short term for sure. Yeah, but you have to think to yourself, am I am I collecting the stocks for like, a shiny trophy? To say, Look at me, I made 200% on the stock. Are you doing your stock investing for that? Or you're trying to build your entire wealth over time? And so really, when you're putting new money in a lot of what you've done in the past shouldn't necessarily factor into too much. Right?

Dave

14:59

Yep, I agree. I think those are the best ways to try to think about it. So I hope that helps, Mike. Alright, so let's move on to the last question. So I have Hi Andrew. just listened to the interview with Christine short. I enjoyed it and my ears perked up at the end, when she mentioned that dividends are decreasing. Would you be able to get into this one on your show? Thank you so much sincerely, Katie.

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So this is this is a great question. And we had a really great interview with Christine short from Wall Street's horizon a little while ago, and very smart lady. And she talked a lot about earnings and everything. And she's really tapped into what's going on in the markets and with these companies. So it was a great interview. If you haven't listened to it, please go back and check it out. So what are your thoughts on the dividends decreasing?

Andrew

15:41

What Christina had mentioned on the interview we did with her was she had done dents and how looking at the upcoming quarter, they were seeing more companies decreasing their dividends then increasing. So it makes sense coming on the context of people expect a recession. So companies are either cutting their dividend to react, or I guess, to prepare or that they might already be having trouble.

And so they're reacting to the trouble. So I feel like she was more just talking about what's upcoming, without necessarily saying that over the long term dividends are decreasing. One way I feel like you can kind of check to see how our dividends doing in the market is you can look at the s&p 500 index ETF. So one I like to reference a lot is ticker SP y. So if you just go into Google, and you type in SP y dividend history, you can see how much in dividends that ETF would pay you. And you can see that over the long term, those dividends increase in the short term, during tough times like this, you do tend to see the dividends come down.

So what does that tell you maybe more companies struggled and not to increase that dividend. But over the long term dividends do tend to increase so I would not put too much nervousness is not the right word. But I wouldn't put too much negative headspace towards what's happening with dividends next quarter.

Dave

17:11

Yeah. And I think it's probably best to look at them as on a company by company basis, as opposed to looking at the overall market sentiment, because it's really more important about what companies you're investing in, as opposed to the market sentiment. And if Coca Cola is still doing great, and they're still growing their dividend, that and you're an investor in Coca Cola, then how does that really impact you that another company is not increasing their dividend, if you're not invested in a company, I don't, it's going to be a company by company decision that's going to be made by the management and the board of directors in they're not going to give two hoots whether Pepsi increased their dividend or not.

And Coca Cola is not going to base their decision on what another company does. So it's really more, I think it's more important to consider what's going on with the companies. And on a case by case basis, as opposed to worrying about the overall market. Can we touch a little bit on maybe dividends? And why a company would choose to grow them or decrease them kind of based on what's going on with the financials of the company?

Andrew

18:15

Yeah, obviously, you know, I don't want to speak for every CEO or board of directors out there. But in general, companies will pay dividends back that they don't need for the business. So for a lot of dividend payers, when they cut a dividend, that's usually a thing of last resort, because people rely on dividends. So, you know, we talk a lot about how a lot of people go into the stock market for different goals.

An example of that could be something like a pension fund, or they're not trying to become the next billionaires, but they're trying to have enough income to support the people who work at this company. So pension funds might rely on dividends. And so if a pension fund as Coca Cola and Coca Cola has doesn't raise their dividend, you're now you're affecting the well being of real people. So companies understand this, and they understand why some investors will buy their stocks.

And so they take this responsibility very seriously. Not all companies, I mean, some companies like those that are really volatile, and those that are tied by commodities, they might just pay a dividend whenever they can, and you just look at the track record, and you can see, okay, maybe we'll get a dividend, maybe we won't, but a lot of companies will pay steady dividends or increasing dividends. And seeing that dividend decrease can be very painful. And it could be a signal that a company is in trouble. So what does that tell you about, you know, where companies see the upcoming quarter, you can really interpret that a million ways. But again, it's really is on a company by company basis.

Dave

19:51

All right. Well, with that, folks, we will go ahead and wrap up our conversation for today. I wanted to thank everybody for taking the time to send us those fantastic questions. These were great. Please keep them coming. If you have any questions about anything, please check out our website investing for beginners.com.

There's a great big search bar up there to the top. You can search for any of the topics that we talked about today. And you can learn more about the stock market. It's a great resource for you to help you learn more about what's going on in the markets. And with that, we will go ahead and wrap it 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.

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