IFB269: VTI (Value Trap Indicator) and Beyond

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Dave

0:00

Alright folks, welcome to Investing for Beginners podcast today we have episode 269. Today we're going to answer a three part question. We got a great question from TJ. And it covers kind of a wide range of different ideas. And we thought this would be kind of a fun conversation. So, without any further ado, I will go ahead and start reading PJ's question and then we'll go ahead and answer it for him.

So here we go. I recently purchased your VTi. I love Excel and nothing gets me more excited than seeing how a workbook flows and works. And I feel have a good understanding of the version 6.0 and a version 7.2. Regarding what each sheet is analyzing. However, when I get companies in that gray area, I am emotionally torn. So I think let's talk about emotionally torn and kind of the gray area. I think that's probably a good place to talk about. And Andrew, I know you had some eloquent thoughts you'd like to share with us.

Andrew

0:54

We'll see about that. Yeah, TJ totally relate with, you know, being the numbers guy liking to look at the spreadsheets. Unfortunately, with the stock market, it's not always as black and white as we would like it to be. I think when you're a beginner starting out, it can help to kind of look at the stock market with that lens. And the I come from a background where I grew up playing a lot of chess, and chess is very black and white. Like there's no ambiguity to if you made a good move or a bad move, after several turns, you'll be able to see if you made a good move or a bad move.

But the business world investing the stock market, these things are less like chess, and more like a game like poker, which I also grew up playing, where you can actually make a very bad move in poker. And you can get bailed out by a great card at the turn or the river. And so sometimes when you're playing poker, you might think you're better than you are. Because you got lucky, if you're not a poker player, or a chess player, maybe you watch some sports. And you can see some coach makes a crazy move. And if it works out, everybody calls him brilliant. If it doesn't work, everybody calls him dumb.

But that doesn't always mean that the decision itself was smart or dumb. So when we look at the business world, we have to look at the gray area of it, which means that things aren't always black and white, because it's sometimes uncertain, and it can be unfair. But that's just kind of the way the business world works. So we do while the numbers help us paint a picture or picture should not be black and white, it shouldn't have color.

Dave

2:29

And I think it's impossible. In the world of business, just as in life. To have certainties and uncertainties, it's going to be really, really hard to determine a black and white situation. Because when you're dealing with markets, you're dealing with other people and you're dealing with emotions, one person may think is great results for a quarter or a year result, another person may think that they're not great. And so they will buy in or sell the company based on their thoughts and their feelings.

And it's rarely black and white. And especially when you're dealing with thinking about the value of a business over a long period of time, whenever we do any sort of valuation work or think about what could possibly happen. It's not black and white, we don't know for sure that Google will grow at 15.2%. Over the next 10 years, we just nobody knows we don't know what the future holds. And we don't know how well things are going to go. A perfect example of that is a company like Berkshire Hathaway, the two leaders of the company that have been foundational and growing their business to what it is, are older. And Charlie is 99. And Warren is 92.

And at some point, they will no longer be working at the company and don't want to be morbid, but it's coming. And nobody knows how that company is going to react or investors that own that business. Nobody knows how that's going to impact the future returns of Berkshire Hathaway going forward. We can't say for sure that the company will stay together. We can't say for sure that they will continue doing what they're doing. They may end up becoming, you know, the next big crypto fund but nobody knows. I'm not saying that's gonna happen. But you get what I'm saying.

There's so much ambiguity and so much unknown that that's something that you have to learn to, I guess embrace and understand and the idea that Andrew was talking about with the football coach or reminds me of that. The play during the Superbowl when Pete Carroll of the Seahawks threw that past against the Patriots and it was picked off and immediately all the armchair quarterbacks started screaming about what a horrible idea. I was one of them. Like when in the heat of the moment watching the game, it was like, Are you nuts? I mean, they had one of the best running backs in the league who had been killing the Patriots the whole game, and that was their physicality. They're really close.

This is it to win the game and they threw a pass it was intercept Did you know Tom Brady won again, and everybody was screaming about what a bad decision it was how lucky Tom Brady was. But in hindsight, when you looked at the actual numbers, which is what Carroll knew the coach, that all the passes that had been thrown on the one yard line or less, it had never been intercepted. And the completion rate was very, very high. And so the likelihood of that place succeeding was extremely high. And just the circumstance that didn't turn out that way. But it doesn't mean that decision was wrong, the outcome was not great.

But the decision was a great decision. And I think when you think about the stock market, you have to kind of think about the same ideas, sometimes you're going to make great decisions, you're going to find very black, what you think is very black decisions that are super easy for you to make. But then the market is going to interpret it a different way. And so I think with that there are no certainties, there is no slam dunk investments. There are no slam dunk companies that you can put your money in, and it's going to be amazing. I mean, I love VSA as much as the next person, probably even more, but there's no guarantee just because I think it's great that it's going to be a great return over 20 years.

So anyway, I'll get off my soapbox. And I just think that I love Andrews ideas. And I think he need to really listen to what he was saying. And that'll help alleviate some of the stress of thinking about whether something's black or white and bracing some of the gray I guess. Alright, so let's move on to the next part of the question here. Alright, so TJ continues. Anyways, I'm looking into stock with what I see as a good potential with a chip crisis, it's Intel. And looking at it based on version six, it looks like a strong buy VTi of 174 If I were working at it at the deep value approach.

So I go into the long term value approach long term with a 5% dividend sounds like a great time, and I can build the drips to my coffee pot. So loved your analogy. So Andrew, what are your thoughts on kind of the second part of TJs? Question and kind of the I guess the the value approach that he's kind of talking about

Andrew

7:01

a little bit that context of this, it's kind of a longer question. So we're having to split this up a little bit. But he's talking about the VTi, which stands for the value trap indicator, it's a formula I created years ago, and have been evolving over time, as my approach evolves. The first version, version six, tries to give you a deep value approach, which is very numbers focused. And it basically tries to find stocks that are hated, and are very, very cheap. And then with the understanding that a lot of times the market overreact to bad news or bad businesses, and the stocks will come up, sometimes really quickly. So that's kind of the deep value approach.

And I realized that that takes a lot more flipping of rocks, you have to buy a lot more, sell a lot more. And I learned this just doesn't fit what I'm trying to achieve with investing. But it can be valuable for people who want to do that. So I left that as a version people can follow. And so version seven is more about kind of looking for a company with a long term approach. Going back to what we were talking about with the black and white versus the gray thing, I almost wonder if you don't mind the activity that comes with buying cheap and selling and buying cheap and selling and buying cheap and selling, if that's almost a better approach for somebody, because you can be very black and white.

Because it's very, you know, as long as you know, a company is not going bankrupt. If it's trading at like such a low valuation compared to where it should be that can be pretty black and white. Just the question is, how long does it take for it to go back to where it should be?

Dave

8:39

And it also calls into question, the amount of activity that you would have to do to, as you were saying, kind of to turn over those rocks. This was kind of the approach that Ben Graham started, and I think I've kind of copied early on in their careers was having a lot of, I guess, cigar butts. And then kind of flipping those, when they would start to mature Walter Schloss that he was kind of famous for that too.

And I think there's some merit to that, if that is the kind of investing that you want to do. I just think that for me, it just takes a lot more, it would take a lot more effort to continually look for companies like that and kind of turning them over. What are your thoughts on that versus more of a, I guess a longer term approach is the VTi. It kind of sounds like you have two versions of it that kind of can feed both kinds of, I guess needs, if you will, Andrew

9:32

I think it's key to remember that the d value approach, you really need to be super diversified with that. It's hard because in investing, there's a lot of conflicting ideas. And so the idea of focusing on just a few companies is not going to work on a deep value approach. So there's these little details that sometimes can get lost in implementing these strategies successfully, that you got to make sure you don't get your wires crossed. Ben Graham, you mentioned a great example of Bangor RAM, he bought something like 300 stocks.

And so I was like, a lot of those are probably not going to work out. But the ones that do are gonna pay for the ones that don't. And because I have 300 of them, I'm solely on the numbers, kind of going back to that Pete Carroll idea in the Superbowl, you know, 10 times and he runs out play nine times it works out great. But if you have one shot, baby, sometimes the less risky play is to do you know, especially if I'm how they know you're about to throw pass, right. But from a numbers perspective, so if you're playing the numbers game, you need to truly play the numbers game, which means spreading out and having lots of positions.

And I think that's something that sometimes gets lost. But if it's a very black and white thing that you want to try to do, make sure you're doing it. But I think it's a great way to invest. I mean, Patrick O'Shaughnessy as one of the better podcasts in our space. And his firm does that. They do it exactly. And it works very well for him. And it is a long term approach as well. It's just a very active, very numerical, very black and white long term approach, or a quant kind of idea that yeah, we're basing it more on the numbers as opposed to qualitative things like, you

Dave

11:09

know how great the manager is idea? Yes, yeah. Okay, then that may appeal to somebody like TJ who's struggling with the black and white versus more of the gray version. And that may be So what basically what you're saying is, don't buy all bank stocks. With this kind of approach.

Andrew

11:29

Yeah, you got to be fully diversified. And not just having lots of stocks, but throughout industries as well.

Dave

11:34

Right. So if you own a portfolio of three or four companies, this is probably not the best approach to take with that kind of idea. All right. Cool. All right. So let's move on to the last part of today's question. However, I don't know what to do with this information, or where to go from here. I went to the Google analyzing the emotional side of it, and no one speaks great about Intel, and bashes it on their 5% dividend wondering when it's going to drop to resolve their free cash flow, do the money spent on fabs in 2022.

The numbers show that this should not be a good buy, but I feel like it could be do I keep my emotions out of this and move on? Or what further analysis can I look into to justify the great version six results and the subtle red flag and diversion 7.2? Maybe I need to do a tenure analysis. And it could potentially dilute this one hiccup of 894. That's the number torn and confused, TJ. So this is a great last part of the question. So what are your thoughts on this last part,

Andrew

12:35

so they give some last context, then Intel, when he ran this and scored really, really well, on the deep value VTi, the long term VTi, which the point of that is to kind of look at the business and see if things are deteriorating. And if it is giving you this red flag saying you should probably stay away. It also scored gray and the d value, but it's scored not as great on the long term, because the balance sheet was going in the wrong direction. And so he's asking, Do I go for the d value approach?

Or do I look at the long term like it's still good long term? He's basically saying it looks good to him on the d value approach. He feels emotionally really good about it. But he's confused because the long term DTI says it could be a red flag. And he doesn't see things on the internet that make him feel like he's making the right choice. I guess that's how I would kind of to give background again to people who aren't familiar with all these terminology. So I know you do own Intel. So maybe I'll actually we'll have you weigh in on this versus me.

Dave

13:41

Right. So I guess, I guess some thoughts. So first of all, since TJ sent us this question, Intel has actually come out and now it's that they have cut the dividend by almost two thirds. So it's, it was a huge drop, the stock price didn't react much in the market, because I think everybody expected them to it was kind of the kind of had to they really didn't have much choice. The company has been on the struggle bus for several years.

Now. They are trying to attempt a turnaround. And those don't always work out very well, as a matter of fact, I think most I don't know what the numbers are. But I would say probably most do not. And so I think when TJ goes on the internet to look for positive things to say about Intel, there aren't a lot. A lot of people are very negative on the company, very negative on the management is leading the company.

And because the company when they announced their quarterly earnings about a month ago, they had the opportunity to say that they're going to cut the dividend then and everybody would have expected them to because they had a terrible, terrible quarter. And they're losing money and they announced that they're going to be laying off people and that management was taking salary cuts and they're doing a lot of things to try to conserve money cash, because they need to spend that money to try to continue their turnaround And that's all logical. But when they don't announce a dividend cut, and then a month later they do, it doesn't look good.

And it just looks like they're reacting to something instead of being logical and saying, Hey, this is what we're doing, we got a plan, this is what we're trying to do, it just seems a little iffy. So anyway, that being said, the numbers for the company right now are awful. And they're whizzing money, like Andrew said, the balance sheet is going the other direction. It's not as strong as it once was, because their revenues have been dropping consistently over the last few years. And that's leading to deterioration in the balance sheet. And so they're having us up there, basically, think of it like a savings account, they're taking money in their savings account in the balance sheet in the form of assets.

And they're using those to try to keep the company going, at some point, they're going to run out of that. And then they'll have to make other decisions about either issuing equity or selling off, you know, buying getting debt to try to raise money. Anyway, all that to say the company is it's on the struggle bus, and there's no two doubts about it. And if you look at the version 7.2, it's giving you a red flag, because of all the things I'm talking about, it's everything is going in the wrong direction.

Segment wise, all the segments are down, the revenues are down, they're cutting the dividend, which they need to do their free cash flow is down, I've also read, which is more quantitative or qualitative, I've read that they're losing a lot of people, a lot of their top talent is fleeing the company because they're losing, money is going down. And they're going to other companies that are doing well because they can make more money. And so they're seeing a talent drain.

And that's not that doesn't bode well, either. So those are all things that I think can certainly put me on the it's more than just a subtle red flag to me, it's, it's a lot of red flags. And I haven't made a decision yet and what I want to do with the company, but there hasn't been a lot of good news recently about the company. And so for me, it's I would not buy it right now. And I'm certainly not putting more money into the company right now. Because they don't, I haven't seen anything from the management that indicates to me that this turnaround that they're attempting is starting to move in the right direction.

Think about it them as the Titanic trying to steer around that iceberg. And it's coming. And the iceberg is bankruptcy, and it's coming and they're trying to steer around it. I'm just not sure they're gonna make it yet. And so for me, I'm not gonna put more money into a situation like that, but I'm not gonna sell yet. But it's just those are all things that would give me pause. Now, I guess, let's talk to the deep value investor. And Andrew, would you you know, if you were looking at the company based on more of a devalue approach, what would be your considerations with the company,

Andrew

17:47

it would be that you're trying to find five companies or 10 companies or 20, companies like this. And like you said that even if nine out of 10 of them don't work out, one of them could, it could turn to the round so well, and if Intel ever returned to its former glory, be coming, that's easy, what triple, quadruple plus, or, you know, and the huge long term compounder. So that's just kind of the way the math works behind it. So if I was a deep value guy, which I'm not anymore, that would be how I would try to approach it.

Dave

18:23

It's not easy. And this is what makes investing a challenge. And mostly, it's not about the numbers, it's about our mental state of mind and what we think could happen with the company and how we would react to that and be a one of the things you can think about with Intel is do you want to wait for that turnaround to happen, it may take three, four or five years for this to happen. And you have to ask yourself, is that something I'm willing to wait for now, from a devalue approach, it could turn around faster in regards to the stock price. If there's the start to see a little glimmer of hope you could start to improve the metrics and the market will react to that. But if things continue as they are, you could be in for a long, long, long wait, but that's what makes investing hard.

Andrew

19:07

Well, if I could paint one more shade of gray on. I feel that we've talked a lot about your intel. And I think it's naturally the talk about it's natural to talk about companies that have burned us. But I also know around the same time that you were talking about Intel, you're also talking about companies like Prudential and a company like Berkshire, where I remember back then there was also not, I wouldn't say it was like negative but there was a like negative or especially around the whole insurance thing, because everybody was freaked out about the pandemic, right.

But you looked at those numbers and you said, everything's going in the right direction for Prudential, everything's going in the right direction for Berkshire. So I'm also going to buy these companies. And that turned out really, really well. Yeah. So you know, looking bbat one situation where the numbers don't work out for you is maybe not a great way to evolve. You wait, if these things can work out, especially because something like technology is so for lack of a better word, like a whirlwind of outcomes, whereas something like insurance, it's not so hard if they booked a lot of business last year, they can book a lot of business next year. And you wonder if that's why buffets really state and really simple businesses, because those numbers mean a lot more.

Dave

20:24

Yeah, they do. Those are all great points. And that's the beauty of investing is you can find lots of great choices and stuff. And you just have to kind of stick to what you know, and try to improve on a daily basis. And hopefully, TJ will help to answer your question. So if you have any questions about anything that we talked about today, we threw some jargon at you today, and we tried our best to explain it. But if there's something that slipped through, that you're not familiar with, check out our website, e investing for beginners.com big huge search bar on top there 1200 articles, just type in what you're not sure about.

And you'll find something that can relate to that that can help you learn more about a particular topic. It's a great resource for you to help learn more about investing. That's why we put it all there. So without any further ado, I'm gonna go ahead and sign us off you guys go out there and invest with a margin of safety, emphasis on the safety. Have a great week, and we'll talk to you all next week.

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