IFB281: How to Hold a Company Rising Quickly/How We Look for Quality Companies

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Dave

0:00

Alright folks, welcome to Investing for Beginners podcast today we have episode 281. Today we're going to read to great listener questions we've got recently. So let's have any further ado, we'll go ahead and dive in. So here we go. I Andrew hope all as well. I'm a big fan of yours and the investing for beginners podcast. Keep up the great work. I bought Nvidia stock around November of 2022. And a stock has done amazing this year. I feel the stock is overvalued at this point. So how can I minimize the risk of losing my gains?

Should it take some profits to lower the exposure or sell everything and find something else? I tried to keep only 3% of anyone's stock in Nvidia is now about 3% of my portfolio. I have 40 stocks in my portfolio. Thanks. I look forward to hearing from you all the best Carlos. So Andrew, let's unpack Carlos was great question here.

Andrew

0:48

Well, first, Carlos, Thanks for writing in. And congrats. Kudos to you for having a video on your portfolio that's been a big winner. So you should feel proud of yourself that you have that stock in your portfolio. And so if I go a little hard on you in this episode, please know you've done a good job. And this is like a good problem to have when we talk about potentially trimming a winner. But I do hope you'll find some value out of this. So I'll kind of start and talk about how my my hall of fame has kind of become my hall of shame a little bit.

And the reason for that is, you know, I have my monthly newsletter I release it's called the sailor researchy leather. At the end of the leather, there's this little Hall of Fame thing where it shows my highest all time return stocks. And number one on the very top is also a name in the semiconductor space. It's called Lam research. And I felt so smart and like I was such a great investor selling that stock on the game have ended up being like 133%, this is back in 2019. You fast forward just a couple years later, if I were they held on to that stock, it'd be up 400%. So just to tell you that you have to be careful about finding great companies and then selling them too soon, because that's very painful. And also it's just like, sometimes we're wrong.

And I would rather be wrong, and not lose that much money versus being wrong, and basically losing out on the tiny gains because I thought I knew more than the market on the company that I had picked. So it's a tough balance, for sure when it comes to managing a portfolio. But the first kind of pushback, I get this initial idea that wanting to sell a stock because you feel like it's overvalued. As long as you're still confident in the business. I feel like in a lot of cases, just because you feel like something is overvalued doesn't make it true. And if it's a great business, and you can see yourself holding on to it for 10 years. I wish I did that with lamb research.

Dave

2:53

So what would give you an idea that maybe this is something that you would want to continue to hold on to? Like, is it in numbers? Is it in the market sentiment? Is it in your own analysis? Like what would give you? Okay, this is getting expensive? And I want to I'm feeling uncomfortable about continuing to hold it. But what would give you an idea of hey, maybe I should hang on to this?

Andrew

3:20

That's a great question. And it kind of feeds into what Carlos was asking. So there's almost two sides to this one side, you have the stock and the business itself. And then the other side is your own personal portfolio. So Carlos, I like how you brought up that you have 40 stocks in your portfolio. And Vidya is now about 3% of your portfolio. So that to me, gives us a lot of context and helps us answer this. And obviously, we're not giving you personal advice, but we're just kind of saying how we manage our own portfolios.

So from the business side, you ask yourself has something with the business fundamentally changed, that's something you've helped hammer my brain they have now it's like, almost a reflex, it just pops in my head every time somebody says so as I fundamentally change. That's a good reflex to have. So we're not really talking about that. In Carlos, this context, we're really talking about what does he feel comfortable with. And you know, there is a lot to be said about having the ability to sleep at night. And and so that number is gonna be different for everybody. Like for me, for example, last year, I had a lumber distributor that I felt like got to be too high of a percentage of my portfolio. And the reason for that was because it's a very kind of similar to semiconductors. It's a very cyclical name, which means that our profits jump up and down like a bungee cord. So it got to a point where it was like, I think six or 7%

My portfolio is like maybe one of the biggest if not the biggest, and then you combine that with the fact that I have pretty big size in home builders, and the home builders and lumber are very tired and they both bounce together. like that. So I felt like, Okay, I have like 15% of my portfolio in this theme, I want to reduce some of that exposure. That hasn't been the right move from a numbers perspective, but it's been on the right move for me to help me sleep at night. So Carlos, if that's where you are, with the 3%, nobody can tell you differently, and make a good case against that. But where I would push back is this idea that you don't want to keep 3% or any stock, because if you're in this game long enough, the best, there's only a few companies that can call themselves the best. That's just the way capitalism is. And so if you're constantly cutting the companies that are doing the best and proving themselves to be the best businesses, and you're constantly chopping them from your portfolio, because you're getting uncomfortable, then I think that's a whole nother conversation, too. So I don't know if you're there or not. But this idea of like saying, I want to keep only 3%. I think it's for the type of investing I tried to do, which is try to hold the best businesses for as long as I can. That's not a conducive approach. How do you feel about that? Do you agree, disagree? somewhat agree?

Dave

6:11

No, I think I guess the way I tried to look at it is, I understand the idea of getting uncomfortable with a company being a larger part of your portfolio or growing into the rules that you have set up, I guess a couple of things that kind of springs to mind when I kind of think about this idea. Number one, the concept that Peter Lynch talked a lot about so many people, pull the best stocks and water, the weeds kind of idea. And I guess when I think about Carlos, his portfolio, this is, of course, sight unseen, is if I had a company that was a great business, like Nvidia appears to be rising, you know, the cream rises to the top, I would look at other companies in my portfolio, and consider maybe if they were not a good fit at this time, and allowing Nvidia to become a bigger portion of the portfolio grow into a bigger portfolio, that's a good problem to have when you have companies that because they're performing well.

They grow into bigger and bigger pieces of their portfolio. Warren Buffett with Apple, that's kind of what happened has happened to him is that he bought a lot for sure. But because it performed so well, it grew to a very large portion of his portfolio. And so I guess those are all things that I think about when I'm thinking about this particular idea with Nvidia is that thinking about okay, and also what kind of runway Does the company have is one thing to go, Okay, I think something's going to turn here, and maybe they're not going to perform as well over the next 510 years. And maybe it's now's a good time to reduce my exposure to the company. The other flipside of that is, you know, hey, I think this is really, there's going to be a secular trend, where this is going to get even more play.

And it's going to be even more of a valuable resource, or product, or commodity that they make, that will spur even more growth for the company, because the stock market is going to reward Nvidia for performing well in their financials and executing on their plans and does that narrow thing? And so I guess that would be the question I would ask myself before I would, you know, the company is like, where else can it go? And how likely is that? And I guess those are some things that I think about when I kind of think about this question is I would want to analyze, where's Nvidia gonna go? What can they continue to do? And then what kind of opportunities may I have in the portfolio, other things that maybe I could swap out for a bigger portion of Nvidia, but you know, if you have a 3% rule, and you have a 3% rule, and that's worked for you so far, then, you know, by all means, stick to your guns, but I tend to operate a little more in the gray when I think about some of these things.

And so that to me, is a little more, okay, this is maybe I'd rather have 6% of Nvidia than 3% of this and 3% of something else, you know, I guess that's kind of the way I look at it. But the at each zone, it really comes back to like Andrew said, whether you can sleep at night, and if you can't sleep, because you own Nvidia, then you know, that's another conversation to have.

Andrew

9:10

I don't know if this is helpful, but if you're the type who's trading a lot of stocks, like you're constantly rebalancing, you're constantly selling high and buying low, I would say sticking to the 3% rule is the best thing to do. Because a very like high frequency, sell high buy low is very conducive to being very strict on your rules, something I've tried to move away from and kind of be more longer term like you Dave is finding better businesses and letting those compound and that's where sticking to the 3% rule probably won't be as effective. It is interesting when you talk about the secular thing, because with all the chatter with the AI stuff, you know, Google Bard versus being whatever that may be.

All it's doing is driving more demand for the serve. or is that our AI? And who is making the chips that power the servers? It's Nvidia. So it is an interesting, I find it to be an interesting dichotomy because we had a listener, maybe a month or two ago who said she only had three stocks, and one of them was Nvidia and that's crazy. To me. There's other listeners, like on the other extreme of that only having three per set. So you know, for whatever it's worth, hopefully, we presented like the two, we can draw the two extremes closer to maybe what's best for the average investor. And Carlos, for what it's worth, I agree with you, I think it's overvalued. That's why I haven't pulled the trigger. But just because I feel that way. And you feel that way doesn't mean that's what's going to happen. So you just kind of tried to take in all the information and do what's best for you.

Dave

10:44

All right. Well, let's move on to the next question. So we got this great question from Luke. It's more like a statement, but we're interpreting it as a question. I love it. I would like to see more case studies to get more practical about your rules to look for identifying healthy stocks. This is from Luke. So this is a great kind of statement slash question.

And we thought maybe we could talk about a company that we both own, to kind of give you some practical rules for identifying healthy stocks. So you want to reveal from behind the curtain, which company we're going to talk about?

Andrew

11:14

Sure. So we're going to talk about watsco, which is a company I recommended last November to business I love. I know, Dave's grown to love it, too. So maybe we can talk about some of the numbers, particularly the watsco that make us excited. And maybe some people will find that useful, too.

Dave

11:32

Yeah, I think they would, I'll freely admit, when Andrew first started talking to me about this idea, I was like, I kind of turned my nose up at it a little bit, just because I wasn't familiar with the company. And it just sounded too boring. But as we've said many many times before, boring, boring is good. Boring is beautiful. So maybe for those Can you kind of give a 32nd snapshot of what watsco is and kind of what they

Andrew

11:56

do. And so if your AC breaks, you need a new AC, you go call a contractor, the contractor is going to install you a new AC unit to buy the AC unit, the contractor is going to go to a middleman. So they're not going to go direct carrier, for example, but they'll go to the carrier distributor Center, which is what watsco Ron's and so watsco actually will brand those centers, but they will be the ones operating them. And they play in that middle role in the H Pak industry.

Dave

12:28

Okay, awesome. So what about watsco? Makes you feel like it's a healthy stock? Like what what are some of the numbers, and some of the things that you can look for to help identify companies like watsco.

Andrew

12:42

So I would just start with the Super basics. And I look at this with a restock. One of my hard and fast rules to talk about rules that you don't want to break is I don't want a company that's not making money. And that's because for me, I like stable businesses that have already established themselves. So you can look at something like a price earnings ratio, or even just look at their income statement. Hey, they're making a profit. It's a positive earnings. So that tells me that the other thing I like to look at is historical revenue growth, which is sales growth, which means are they selling more by dollar amount over time, it doesn't need to be perfect doesn't need to be up every year. But over time, averaging out raising that pretty good for watsco. Over the last 10 years, it's 7.9%. It's not crazy tech numbers.

But it's it's pretty good, especially for a boring industry. And then one of the other metrics I highlighted in the beginning of my E leather issue for watsco, nine consecutive years of dividend increases. So they have shown through their track record that they're committed to returning some of their profits back to shareholders through a dividend. And I like companies like that.

Dave

13:50

So can we talk a little bit more about the revenue part of it? When you're looking at the revenue of a company do you look for, okay, it's grown in the last two years, it's grown in the last three years, it's up one year down two years? Is that more of a longer term number that you're looking for? I know our friend Braden has he's looking for 10%? or greater? Do you have a ceiling that you're looking for? Or is it just more of a I want to see growth? And then kind of, you know, assess it as part of the analysis further down the road?

Andrew

14:21

That's a great question. So I wouldn't say I have a ceiling, I maybe have a floor where if you're looking at like two or 3% a year. I don't really like that necessarily. And unless, unless I think that a company can grow its profit margins, then I'm not going to look at a company like that, in general, at least over the last several years. So when I say two to 3%, what I'm talking about is the average over a longer period. So I like to look over 10 years. And I like to see kind of like different cycles like how did they do in a tough economic cycle how they do in a boom Assuming the economy and how did that average out. And so either use like a arithmetic average or a median average, if there's big swings, will do either of those two things.

And so that's kind of the framework. And the reason why I feel like that works well is because companies will make themselves more efficient. In other words, they will increase their profit margins. But you can only do it so much. If your revenues not growing, you can only optimize so much. At a certain point, you squeezed the orange until all the juice is gone. But if revenue is growing, then a lot of great things can happen in the business and they don't have to squeeze and optimize, which a lot of times actually kills a business when you do that.

So if what that tells me if they have a pretty good, above inflation, revenue growth, that tells me that they're in an industry where people like their products and services that are willing to pay up for those products and services. And as long as I have that in a company, I can see it doing well over the long term, I would

Dave

16:06

hypothesize easy for me to say that we see a more mature company, I'm not saying the watch goes mature. But when you see a company that's been around for a decade or two, and you still can continue to see, you know, consistent revenue growth, whether it's 6%, or 12%, that to me also indicates a company that has at least some modicum of a competitive advantage, because competition is going to come in and try to eat at whatever company is being successful. And so a company like watsco, if they have 7.9%, over 10 years, then indicates they have some way shape or form of a moat, or competitive advantage over their competitors, because they continue to grow faster than the economy and inflation. So those are great things.

Andrew

16:49

Yeah, those are all really good points. I'd be curious what metrics kind of jump out to you when you're first looking at a company like watsco, where you're like, Okay, this, this looks like something I'd like to investigate further,

Dave

17:00

a lot of the same things like initial is, obviously it's going to be top line growth or revenue growth, looking at the income statement and trying to determine how well they're doing over a three year period, a five year period, a 10 year period. And when you have a company that's been around a longer, like, let's go, you can also look back and see how they've done during some downtime. So like the.com era, or the great financial crisis era, or even how they reacted during the pandemic, all those things help tell a story of how efficient how successful the businesses, how well run they are, you know, what management and how well they have a great sales team and a good product. You know, it all comes down to those kind of basics.

And so those are some things that I will definitely look at. I guess the other part of that too, for me is I would try to determine who their competitors are. And look at the competitors growth rates, as well, just to kind of get a sense of like, are these guys the best or the second best or third best kind of thing? It doesn't necessarily disqualify them, but it just helps me give a gives me a, I guess, a general overview of the company and industry

Andrew

18:05

that it operates in. And its most, like you said,

Dave

18:09

Yep, exactly. So I guess moving past the earnings slash revenue part of it, what would be another thing that you would kind of consider what's a rule or quote rule to identify a healthy stock,

Andrew

18:21

um, I don't know if I call the rule. But other run that through the value trap indicator, which is one of my screening tools, and that basically just says, it just looks at a company's financials. And if the balance sheets deteriorating, then it will flag and then if it flags, I'll look deeper. If I think if the balance sheet is not moving the way I liked, and I'll move on, sometimes I'll make an exception to the rule. I guess the other thing I would look at would be return on invested capital, which I don't know if we've done a complete bird's eye view on it.

But I feel like we've hit on it several times. In past episodes. Yeah. But for me, I want to see a decent return on capital, knowing what all companies earn, on average as a return on capital. I want to see a little bit higher than that. Because to me, it says all of the things that you said it's an efficient business operation, and that's probably because they're serving their customers well, and their employees are doing an efficient job, all of those things and return on invested capital can help you start to identify that.

Dave

19:24

Yeah, it absolutely can. It can help you identify well run companies, it can help you identify companies that are efficient, it can also help you identify companies that reinvest really well. That's really the foundation of what return on capital without going into the nitty gritty of it. It really comes back to how efficiently the company allocates its capital to grow the business and that goes to a potential moat. It also goes to how well run the company is which indicates management, quality, the management or the capability of the management. And it also indicates What kind of growth opportunities the company has. And it's without going again, without going into the nitty gritty of it, the higher the number, the better. And that's really one of the things that you really want to look at.

And it can be a great screening tool, especially if you're looking at companies like watsco in their industry, it can help you disqualify other companies, because you would rather have a company like watsco, that does a fantastic job of reinvesting versus, you know, other competitor that does not, it doesn't matter what company it is, it doesn't matter who it is running the company, if they don't invest in their business efficiently. And well, in the long run, that business will not be successful. And it's really that simple. And so that's one of the things that Warren Buffett focuses on very, very much is returns on capital, and it indicates all those things to him and Wasco. When you look at it, that's one of the things that you can tell right away. It's it's a quality company. It's not the only thing but when you put it into context with all the other things that we've talked about, it's just another data point that helps you go okay, hey, this is this is a good company. Oh, yeah,

Andrew

21:03

big facts. And to kind of tie in with what we were saying earlier. I might look at two companies that are competing against each other in the same industry, one might have a higher growth rate, but if their ROIC is really, really low, and another company has a decent growth rate, but a really good ROIC, then probably, you know, depends on the situation depends on the industry and how mature it is, but almost prefer to see the higher returns because to Dave's point, a lot of the times really low returns are not sustainable.

So when we look at watsco Dave and I have our own ROIC calculator, so we we do a little bit differently than people than other people. But I, you know, adjusted for cash, I got five years of ROIC at 17%, and that that's a decent amount higher than your average business. So that definitely has above average growth. So those two things make me look at the long term for watsco and feel very confident about it. Yeah, me too.

Dave

22:02

Me. Me too. I was one of the things that I liked right away about the company. I was like. Alright, so moving on from ROIC. What would be next, I would say, you know, if

Andrew

22:14

you want any more than that, you got to subscribe to the letter, and you can see them laid out.

I mean, Dave's basically tricked me into creating this checklist. Now, I go through when I do a UI there pick and there's all these numbers in there that tell you, you know, what's the financial safety of a company, and also where I think a company's free cash flow is and their valuation because that would really be the last piece is you got to figure out how profitable a company is and how, how much of those profits, they turn into cash flow. And so I think that's beyond the scope of how much time we have left for today.

But that would be I guess, the last piece that's very important would be that valuation piece. And it's not simple. Unfortunately, there can be a lot of details that can trip you off, if you haven't done this for a long time. But that's where asking questions, being curious, trying to learn from other people, that's where that a lot of that can help you get through it, and figure out if a company is trading at a good price or not. Exactly. And I think one thing that I guess a couple things that kind of springs to mind, when we're kind of when I'm kind of thinking about this number one, these ideas that we're talking about to help identify healthy stocks are a great screening tool that you can use to help start analysis of a company or or digging deeper into a particular company, whether whether it's in video, whether it's PayPal, whether it's watsco, these are all a great starting point, they are never an endpoint.

These are not where you go, okay, hey, I got these. I got this company has got great growth, it's got great earnings and it's got a fantastic ROIC or return on capital I'm gonna buy. No, this is the starting point. This is where you start to look into all the other things that matter when you're trying to invest in a company including the valuation or what the price is that you're going to pay to partake in a company like watsco. And so always keep that in mind. You know, these are helpful tools to help you identify companies to dig deeper into, they're never the endpoint. And I think if you keep those rules in mind or those ideas in mind, it'll help you start finding better and better investments over a long run percent.

Dave

24:25

All right, everyone that is going to wrap up our show for this week. I wanted to thank both Samuel and Luke for sending us those fantastic questions, please keep them coming. And don't forget to subscribe to our show on your preferred podcast app if you enjoyed our little podcast. If you would kindly consider giving us a review it greatly helps the show and don't forget to browse the incredible materials we've created for you at E investing for beginners.com. You can find out all kinds of cool stuff that we talked about today like returns on capital returns on invested capital, and banks and all that fun stuff. Lastly, consider growing your knowledge as an investing for beginners insider, we have insights and educational tips delivered right to your inbox for free Sign up today and with that 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