IFB283: Back to the Basics of Building a Portfolio

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Dave

0:00

All right, folks, welcome to Investing for Beginners Podcast. Today we have episode 283. Today we're going to go back to the basics of building a portfolio. So this is not something we've talked a whole lot about. And so we thought maybe we would maybe help give people some guidance on how they could start building a portfolio. Let's say you're starting from scratch. How do you start? So, Andrew? Without any further ado, how do you start?

Andrew

0:24

Yeah, great question. Let's just dive into the deep end, no, getting our toes wet here, let's

Dave

0:30

just dive, no life preserver just jumping in baby,

Andrew

0:33

we're gonna dive headfirst. The whole idea of a portfolio is you want to have your money diversified. Because crazy things happen. We have seen it all the time, we will continue to see it all the time. And even the best businesses go under. So because of that, you want to spread your money out until a lot of different investments.

That's what's gonna make up your portfolio. So I guess, help us visualize that, what does that tend to look like? I know, it could be a really broad spectrum. So maybe you try to narrow that part down? What do you mean, when we say diversify and build? What is portfolio construction look like? Well,

Dave

1:15

I think maybe the backup backup, the first thing you want to decide is what kind of investor Do you want to be, because that's going to go a long ways towards deciding how you want to build a portfolio. So for example, if you want to be a stock picker, like Andrew and I, then you need to consider the the different individual kind of companies that you want to put in your portfolio, making sure that you try to have as much diversification as you can have. And when we talk about diversification, we basically mean, don't have all your eggs, eggs in one basket like Dave did.

And don't put all your stuff in payments, have other things besides payments in your portfolio, because that will help avert any sort of downturns that happen in the sector is different sectors, which can happen from time to time. And so by having a diversification, in other words, that means having your towed as many different kinds of sectors as you possibly can. And let's say this rule will apply whether you are a stock picker, or whether you want to stick to ETFs and index funds, because you can follow the same general kind of rules. If you want to have a more diversified portfolio, there are index slash ETF investors out there that like to have all the sectors filled with indexes, or ETF funds as opposed to individual stocks because they want broader exposure to the whole sector, as opposed to one company that may be the leader in that particular sector. So that's, I guess, those are the questions you want to ask yourself and have answered before you start building the portfolio.

So I guess the first layer of the onion that you want to peel is you want to think about the different sectors that are available for you to start building the portfolio. And keep in mind, it's kind of like building the It's like eating the pizza, you can't eat all once you can have the most people are gonna have to build a school way. Because we can't find 15 to 20 Great ideas in each individual sector immediately. Sometimes it may take you a while to get to, you know, hey, I'm dying to get a commodities. And it just may take you a while to find the thing that you want in that particular sector. So patience is Okay, at this point. So maybe since I kind of mentioned the S word, maybe we can talk a little bit about sectors and then we kind of peel the onion from there.

Andrew

3:33

Sure. So while we're talking about this S word, obviously, we're talking about the stock market. If you go to visor who's doing retirement things, they might tell you to think about investing in lots of different asset classes, which could go outside of stocks and outside of sectors. So they might talk about bonds, they might talk about gold, they might talk about silver, like a guy I met the other day, when he heard I do an investing podcast. He's like, so what's your thoughts about Golden silver? I'm like, let me tell you about businesses. So, you know, we're kind of under the assumption that you've kind of plugged into our idea of building a portfolio for long term wealth and why we think stocks are the best vehicle for that because they're made up of businesses who create cash flows. And so an advisor might tell you something differently if you're close to retirement.

But while we're talking about building a portfolio, that's why we're starting to dig and peel that onion into the sectors. Now the sectors are laid out, you know, whether you're watching it on CNBC, and you can see in the background, they've got these big heat maps with these huge squares, and these little squares and these little rectangles, those are gonna be the different sectors so I'm just gonna shoot them off just so people can kind of get an idea. So, basic materials communication, consumer cyclical consumer, defensive energy, financial how Healthcare, industrials real estate technology and utilities.

Those are going to be the different sectors and at least for the stocks in the s&p 500, every stock in there is going to be inside one of those sectors, you know, just as an example, Apple would be in technology, and a pizza company like Domino's would be consumer, cyclical. So those are kind of how the pieces fit. And I guess the debate starts, or could start is do you want to fill in all the sectors or not, and I guess these answers of if you do want all the sectors, you can just buy an index fund, like SP y ticker, SP y, it will buy you, the s&p 500, which has those sectors in there. But you have to realize that it's at the expense of you couldn't have lower returns, because not every sector is created equally. And some sectors, like utilities over the last 20 years, have not grown nearly as fast as some other sectors, like technology, for example. So kinda like how do you look at the whole sector game? And how do you approach it, when it comes to building a portfolio for somebody who would be new?

Dave

6:13

Well, I think the way I would probably look at it, if I'm starting off new, and I'm trying to kind of build this whole thing, the first thing is I would look at, I would look at all the individual sectors, and then try to find businesses inside those sectors that fall under my circle of competence like that I understand, or that I'm interested in, want to learn about and know something about. And then I would focus on those and try to try to pick and choose those and start to work up from there. And then over time, then I can decide whether I want to learn about utilities, or not. And consider if that's something that I want to have added to my portfolio, or it could also could be a situation where you know, I really want to have exposure to the situation or to the sector. But a, I don't understand what the companies do. And I don't really want to spend the time like, you know, learning what a utility does may not move my boat much.

And so I may try to find an index fund or an ETF that covers that sector and invest in something like that, to help me get some diversification, it could also be a situation where you do that to fill the gap. And then as you get more comfortable with what's going on in that sector, maybe you could learn some of the better companies in that sector and maybe replaced that ETF at some point with individual companies. But if you're just starting out, and that doesn't fall into your category, like commodities, for me would be something I'm like, No. And so that I would probably look for maybe an index fund or an ETF to help fill that gap, if that's something I really want to, to plug in. But I think at first I would want to fill the gaps with the things that I understand and know, and then that would be my base, and then I would kind of work from there. What about you?

Andrew

8:13

I guess, you know, I'm a very value first kind of guy. So when I first started my portfolio, it was where can I find the best companies outside of what sector are they in? So that's kind of how I looked at it and then just trying to be cognizant of, alright, if I just bought two technology names in the last four months, maybe even if I find a value in technology looked somewhere else because those two companies in the same sector could be impacted by the same forces which would make their profits go up and down or you know, at the same time from the same things so how did you you know, outside of like, let's say you're super interested in guitar or something, but no of any musician type stocks in your portfolio.

So how do you personally decide between like I'm interested in this versus I see this as an attractive sector is that happened early on or is that something that you do kind of lay there for me

Dave

9:13

I started to kind of the way you did where I found I was trying to find value where it gets find it. And then once I started to build some of those then I started to try to branch out and see what it was that I could find to start to move away from Okay, I have a bank and I have an insurance company I need to kind of not choose something in the financial sector I need to try to find some value in this you know, fish in this pond.

And then you know, maybe fish in this pond again and then maybe I could come back in the financial sector if I could find some value in that sector. But for me once I started to get to like 1517 stocks in my portfolio, then it becomes more intentional about okay, I need to either find something in the As other sectors, or I need to think about are the best businesses in these particular sectors?

And can I find other things to maybe add or subtract or any of those kinds of things? Not necessarily subtract, but I don't so much, but to, I guess, look at what it is that maybe I could add on that could be a better value, or another strong company in that particular sector?

Andrew

10:26

Are there sectors that you aren't in? And Are there reasons for that outside of you're just not interested in them? Well, right now, like a whole basket of companies under the bus or anything, but no, no, you know, but it is, I think, a valid question, because not all again, not all industries are created equal. Right,

Dave

10:47

right. No, they are. Right now, I am not actively in the energy sector, other than owning Berkshire Hathaway, that's not a direct, you know, investment in utilities, per se. But I'm not in commodities. And that is not intentional. It's simply because at this point, it's not that it doesn't interest me, it's that I don't feel comfortable investing in that sector, because I don't understand it. And I don't have I haven't spent the time or put in the work to necessarily understand the oil industry, or some of the mineral industry, for example, say copper, just to choose a metal. I don't know enough about the copper industry to feel comfortable that I could go out and buy one of those companies at this point.

Andrew

11:38

I don't hope to I wonder about the investor who's new to this and wondering if they're gonna lose out if they don't invest in the sector, right? Like, because I think that the fear of missing out is really strong, especially if you're new. So whether you speak to that that like, look, I'm personally not in commodities. Speaking as Dave here, how does that how's that work with the whole Fear Of Missing Out and wanting to be in every sector kind of a thing,

Dave

12:04

I think one of the things that I would do, would be to look at the returns over the last 510 1520 years of the particular sectors. And if I see that maybe the returns in the depict on the utility industry, let's say that they aren't that great over the last five to 1020 years, then the fear of missing out is going to dwindle quite a lot.

Because if you look at the tech sector, which has done really well, obviously, then that would give you a fear of missing out because you feel like you're missing out. But if you see that you're missing out, not missing out on 2% returns, I'm just throwing I'm just guessing here, I wouldn't feel like I'm missing out because, you know, 2% returns over 10 years is nothing to get excited about. So that would help reduce that fear for me. What are your thoughts?

Andrew

12:53

Yeah, I agree with that. I mean, I'll just straight up say I don't like utilities. It's because they don't provide the growth that I'm looking for. Right. So when I'm looking at a different sector, yeah, I am making these kind of might sound mean to the businesses that are involved, or people who have investments in them. But yeah, I don't necessarily see every sector is equal. I think that's kind of harsh. But I think investing can be harsh. So I think real estate's really tough right now, specifically, commercial real estate, I've reduced my exposure there to one name, which is far away from the traditional commercial real estate names.

And I've done that very intentionally. Well, I guess a lot of that comes with experience too. And to kind of bring it back to building a portfolio as a beginner, I like that framework of, you're not going to be able to find 20 Great ideas in a single day. So it does help take time to, you know, it can take time to build up to that diversification. For me personally, it's pretty much like two years to build up to that. And if you really think about it two years over the span of investment life is not that much.

So I think at a certain point, a beginner should think about fear of missing out on certain sectors, like I learned the hard way with tech. But do you worry about that when you're first starting out? I would not because two years is such a small window over the grand scheme of things.

Dave

14:18

Yeah, it totally is. And I think, you know, like anything else in investing, building a portfolio is going to be personal to you, and what is going to work for you may not necessarily work for your neighbor, and vice versa. And I think the important thing, especially when you're first starting out, is figuring out what you can invest in, that's gonna allow you to sleep well at night. If you're buying company A, B, and C, because you think they're the next greatest thing, but you're tossing and turning every single night for, you know, months and months and months.

Then you got to ask yourself, is it really worth it? And is that really the best choice to start because the studies have shown time and time in Time and time and time again, that time in the market matters more than timing the market. And so whatever is going to allow you to be consistent and continue to invest over consistently over a long period of time is going to give you far greater returns than trying to find the perfect investment at the perfect time. Because that just is that's a fool's errand to try to do that. It's that's such a hard game to play. And there are so few investors that have successfully done it over a career, I don't think there are any. And that's why you don't hear people talk about, hey, this is a way to invest, because it isn't.

And I just saw something on Twitter today, where there was, somebody was showing a chart and you know, the returns that you can get for just investing consistently, vastly dwarfed the ones that where you're trying to time the market, find the best stock and waiting until the right moment to buy it and those kinds of things. The consistency is far more important than the actual execution of buying the perfect thing at the perfect time.

Andrew

15:59

Oh, 100%, I guess Are there any other building a portfolio, kind of big picture, things that investors should put some thought into? We've talked about kind of the sectors and, you know, building into some of those names? Is there anything else that springs to mind, that investors can think of from a basic standpoint?

Dave

16:23

Yeah, I guess it kind of comes back to position sizing to like, how big do you want that particular investment to be? And, you know, there's, there's lots of different states of how you can paint that too. And I think, especially when you're beginning, I think trying to have guests or, quote rules will help you get started. And then as you become more comfortable, then you can learn what rules you can break and what rules you can't break. And what will work for you, what won't work for you.

But I think, you know, try, obviously, when you buy one company, and then you buy another company, you're gonna go from 100% concentration to 50%. And that, you know, okay, that's, that's fine and dandy, but you know, to achieve the, you know, the Charlie Munger, level of diversification of having three or four stocks in your portfolio, that takes a lot, you know, that takes 67 years worth of education, knowledge, experience and wisdom to achieve that. And, you know, I think that's a really, really hard game to play to adjust, I think, you know, trying to find an ideal air, quote, ideal number of stocks that you want to shoot for as a target, and trying to keep those within a range of each other. Whether it's 2%, and 5% 4%.

I mean, it's, it's up to each individual, I get to play with the numbers and find out what's going to be best for you. But I guess the one thing that I always think about was something that Brian for Aldi said to us is that one of the things about portfolio concentration, or how much you divide, the weighting of each company, sometimes starting off small and allowing those companies to grow into a position is a great thing to do, too. Because that can really show that this is the great company that's grown to seven or eight and nine 10% of your portfolio because it's performed so well. And there's something to be said for that, too. So I don't know, what are your thoughts I've been? I'm talking a lot, but I want to hear what you think about it.

Andrew

18:21

Yeah, I love that idea of flipping instead of, it's really easy when you're looking at a portfolio to look at the numbers and the percentages and start seeing the Yeah, like real spreadsheet. But there really are, these are investments and there are businesses that you're holding, and they're going to grow at different rates. And that's very important to think about. If I could just think back to when I was a beginner, it really helped for me to have that framework to shoot for. So in case we haven't said it yet.

The framework that a lot of people talk about for beginners to hit 20 stocks. I've heard value investors say that I've also heard, even like people who do momentum trading, they call it 5% position size, but it's the same thing. 520 stocks divided by if you have 20 stocks, each of those is 5% of a size. That's like kind of the base that a lot of stock pickers start from now where Dave is talking about is if you have 20 positions that are 5% each, and let's say Microsoft and it triples in value at while the rest of your portfolio just grew only 10% of Microsoft triple that'd be close to the 15% of their portfolio. Right? So then you start to naturally get this unbalancing of your portfolio and that's where the gray area can come in and that it's hard it's really hard because from a numbers paper perspective, nobody wants to see your stock and Microsoft.

You don't want to see those gains disappear. A lot of people want to like lock in those gains because they do disappear sometimes stocks do come back down After they've gone up really high, but you have to remember on the other side of that is that that's a real business under there. And if Microsoft stock has tripled, that's probably because they've grown their profits a lot. And so do you really want to reduce the best positions in your portfolio? Just because they've gotten to such a big size?

And then that kind of goes back to the idea, can you sleep at night, so it's, it's a probably just like a never ending balancing act. And that's where it can help to actually go back to the basics and listen to basics about portfolio construction, because then if you can come in with a fresh mindset, you can make good decisions about your portfolio. The big thing, I think, for me that's been really helpful is I'm never perfectly happy with my portfolio sizes. And I've just learned to live with that. Like it really, because you can't, once you start to make everything look perfectly portioned like you would like you're spending too much time micromanaging, all these little things. And the business world just can't be micromanage like that, when you're talking about the stock market and the results of a lot of different businesses.

So you do just kind of have to let go that it's gonna look on organized and messy. But at the end of the day, the more you can focus on the businesses and how they are performing, and then make intelligent decisions on it. So for me, you know, Microsoft was like 60% of my portfolio. That's a different conversation. But if we're talking about it goes from 5% to 6%. Come on, like don't get too crazy about it. So that's, that's how I would maybe try to view it. Of it's just this somewhat organized mess that you just live with, for however long you're an investor.

Dave

21:51

Yep. All right, folks. Well, with that, we will go ahead and wrap up the show for this week. Don't forget to subscribe to the show on your preferred podcast app if you enjoyed our little show. If you would kindly consider giving us a review. It greatly helps us and don't forget to browse the incredible materials we've created for you at E investing for beginners.com.

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