IFB292: 5 Metrics Every Beginner Investor Should Know

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Dave

0:00

All right, folks, welcome to Investing for Beginners Podcast. Today we have episode 292. Today, Andrew and I are going to talk about the five top metrics that every investor should know, we thought this would be a fun opportunity to talk about some different ratios and metrics that could help. In particular beginning and slash intermediate investors get started looking at valuations and other metrics that are important to them. So let's start with probably the most popular one.

And most of the one most everyone is familiar with, which is the P E ratio. Let's talk about that. So Andrew, what are your thoughts on the P E ratio? Maybe we should start with a quickie on how to calculate it. And then we can kind of go from there. Sure, if you're a

Andrew

0:43

stock picker, and you don't know what the P E ratio is, then what are you doing? The P E, short for price to earnings ratio is just the price divided by the earnings. So probably one of the most popular metrics on Wall Street is earnings per share. When companies are reporting on their results, every quarter, they are talking about, where's our earnings per share?

How is it moving, and so you can take that earnings per share, and compare it to the price. So if Apple's trading at 180, and let's say they have $10 earnings per share, you take their price 180 divided by the earnings per share 10, you would have a PE of 18. I wish it was that cheap today, but I

Dave

1:31

do to that time.

Andrew

1:35

And it tells you how much of Apple's profits you're getting when you buy a share of their stock. So if their stock goes down, that price to earnings goes down, and you're getting a better bargain than you did yesterday if the PE went down, because you're paying less or more earnings.

Dave

1:53

Exactly. And that's the ultimate goal is to try to find a company for a good price, or the value. And it's a P e is great metric, especially for starting off investors. irregardless of what level you're at, it's a great tool to help you kind of get a snapshot of maybe where the value of the company is, a lot of times, if you go really deep into trying to figure out what the company is worth, a lot of times, you'll notice that the P E ratio will tell you the final result. A lot of times not always.

But a lot of times if it's really expensive via PE, when you do any sort of deeper evaluation of work, you'll come out with kind of the same result. So it's kind of a shorthand doesn't mean you need to you can or need to skip the other steps as you get more involved in investing. But it's a great shorthand to help you kind of weed through companies. That's what I use it for, as a screening tool to help me try to find potential investments because it can be it can tell you a lot in a little bit of information. And that's why it's so useful. Do we want to talk about a little bit about kind of how to use it? In other words, like you were talking about Apple, you would never compare the P of apple to the key of JP Morgan, for example, who maybe dive into that a bit.

Andrew

3:07

Yeah. Have at it, please. Okay.

Dave

3:10

All right. So a lot of the metrics that you see bandied about any sort of financial news, Wall Street, any sorts of reports and stuff, a lot of those are considered what would call relative valuation methods or relative metrics. And what that means is that you use them to relate them to other companies or industries that are very similar to each other. It's going to lead you astray. If you compare Nvidia's PE to JP Morgan's PE or Northrop Grumman's PE or a railroad PE, just because the nature of those businesses are completely different than Nvidia. It doesn't mean that one is better than the other. That's not what we're saying. What we're saying is, if you try to compare the PE of Nvidia to the P E of Boeing, it's not apples to apples, you really when you use these metrics, and you're trying to figure out how expensive is Nvidia compared to other companies, you want to compare them to others in their same industry.

So you'd want to look at, for example, AMD or you know, micron or TSM, Taiwan Semiconductor, some companies in that ilk, you'd want to compare Nvidia to, likewise with Boeing, you'd want to compare it to United Delta, American Airlines, and anything else along those lines, had a bad experience with American sub. But that's really the best way to use these metrics is to compare them to other companies in their same industry, as well as to their historical averages.

We had a great interview earlier today with Karen fireman, and she was talking about oh, you ought to so if a company is trading at a P E of a weapon, where historically they're trading at Pease at 22, that could indicate that the company is cheap at the moment.

Andrew

4:51

When I look at or when I think about why is to use your examples in Vidya. Why is that semiconductor industry such a higher P II ban something like Boeing, in general, you know, you don't want to say this for every case. But in general, the industry with the higher average P e is probably going to be growing faster than the lower p e industry. And so that's why I thought something that I was never taught. And it took me a while to learn was, this is why you have differences in PE S, is because when you have a business that's growing faster, that's worth more, you know, maybe not tomorrow, but in 10 years, that's going to be worth more to you if the business is growing faster than the economy. And so that's why those will tend to trade up higher.

Now, at other times, let's say, you know, the pandemic darlings that we always like to beat up on, if you want to consider that as an industry, those peas got really high, but because everybody was crazy about this small group of stocks, so every once a while on the market, you'll get these crazes of different stocks get really trendy and really hot. And you're gonna want to stay away from those. So just because the stock has a high P doesn't mean it's a great business. But at the same time, if a stock has a higher P E, ask yourself, oh, is this because it's a business that grows faster than the average business? If so, then that might be justified.

And then you can take the deeper valuation approaches, they have an idea when we're analyzing companies, and then you can really get some hard numbers on whether that is expensive or not. So today's point, you don't want to take PE on an island, you want to compare it to other things. And you also want to compare it to other concepts like growth, because unfortunately, you would think that business is all about profit, and all you have to do is grow profits to get returns in the stock market. Fortunately, it's not that simple. It does take more than just one metric to find good results in the market as an investor.

Dave

6:57

Yeah, it absolutely does. And the there is no, you're gonna find, as you get more experienced in the markets, there is no one perfect metric that's going to tell you everything that you need to know about the companies, Michael Mobis. And one of my art heroes talks a lot about using these kinds of metrics that we're talking about today, as shorthands, for deeper insight into the companies.

And so it's they're great tools to help you screen for companies. They're great tools to give you shorthand to discuss it with other people with the talk about the P or other ratios with investors. But if you really, really want to understand what's driving Apple or Nvidia that you need to dig into the company and learn where I'm at a little deeper level, but as a beginner, and you're just trying to figure out things, they're great tools to get you started. Unfortunately, they're not the ends to the mean, they're kind of the beginning of the yellow brick road, if you will.

So I think we've beaten P E to its death, let's move on to price to free cash flow. I think that's we agree that's probably the second most important one or one of the more important ones. Well, let's talk a little bit about how do you define price to free cash flow, I guess first, and then we'll kind of go from there.

Andrew

8:06

Sure, perfect. So same way we would compare price to earnings, instead of earnings, we're going to use free cash flow. So you take that share price, divided by the free cash flow per share. And that will give you your number, same concept, you know, you want to compare inside of industries or you can compare it to itself, all those same, all that same logic applies compared to the growth.

But the reason you use free cash flow instead of earnings is because businesses take capital investments in order to grow. And if a business is using too much of that, then that could leave nothing for you the industry. So I'll give an example, which is near and dear to my heart, because I'm about to sell this company to a company called step in. And they make this actually makes for a pretty good example, because there are one of those old economy businesses, you know, you think about the businesses that have been around for since the beginning of time with the factories and the cheap labor. You know, not to say that this is the case with this company, but it has the traditional kind of like factory facility kind of deal.

And they make a product that ended up being regulated. So they had to change their manufacturing process in order to keep up with these regulations. And because this is a very long term thing, you can't just erect a factory in six months, it's gonna take several years, and it's gonna take, you know, 10s of millions of dollars to put one of these things up. So they've had to make huge capital investments in order to comply with these regulations. And so that doesn't necessarily show up in the earnings because it's a very long term expense. And it only shows up in free cash flow, which takes into account those capital expenditures you make such as a factory.

So looking at price to free cash flow and set a price to earnings could help you speed up your filtering process if you didn't want to run into companies like the one that we're about to sell, because they have negative free cash flow, and that's not the kind of business you want, there could be an argument to be made for investing in companies with negative free cash flow, if they're investing for growth. But if they're spending a lot of cash flow just to keep their business afloat, that's probably a bad sign. And so that's why free cash flow is a good metric to look at as the next logical step. Okay, I know this company's making a lot of profits right now, are they making long term cash flows for the investors, free cash flow helps you determine that

Dave

10:50

I Oh, yeah, I look at it a lot, probably one I use more than I use price to earnings. Because for me, the idea of cash flow free cash flow, it really tells me a lot about how efficiently the business runs and how well they manage the business. Because if you look at the free cash flow is a calculation that you determine from inputs that you would find on the cash flow statement. And it really tells you the kind of think of it, I always like to liken it to a checking account for the business.

And it's really the money that the cash is coming in and out. An income statement is really more of a financial or an accounting document. It's not actual transfer of money here or there. But the cash flow statement is, and so that really tells you how the money is going in and out. And if they don't have enough money to do use Andrews example, if if the company doesn't have enough ash, to build those factories, then they have to generate the money from some other source. And that could be debt, or they could sell equity in the business. And those are ways that they can raise cash to build those factories if they don't have enough cash flow to do it. And so that's why I really like to look at cash flow, it also relates to doing, you know, discounted cash flow models, and just analyzing the operations of the business.

And it also can tell you something about management, and how they manage the business. You know, there can be CEOs or management that are fantastic salespeople, but maybe they don't operate the business that great. And that can go a long ways towards telling you this error thing. So one thing I think we've kind of forgot to mention with the P E ratio, and with the price to free cash flow is generally, again, depending on the industry or sector you're looking at, the lower the number, the cheaper the company is, because this is again, kind of a valuation or a pricing mechanism to tell you how expensive it is versus each share of free cash flow. And so if a company has a lower one that could indicate that the company is cheaper, because they're not the the market is not pricing, they're not looking at this free cash flow per share as valuable as a company be in the same industry or the same sector. And so that's how I use it is kind of a proxy or a preview for valuation for a company.

Yep, I think one other thing that I wanted to throw out there is with the first two that we talked about, you can also use them as like a yield, like what kind of return you might expect if you bought the company at this particular ratio. So if you look at a P E ratio, and you flip it upside down, so instead of it being the price over the earnings, you do the earnings over the price, and you do the same thing with a price to free cash flow. So if you inverted those numbers, you could expect a return of 10%.

Is that guaranteed? Absolutely not. But it could give you some idea of what kind of return you could get if you invested in this company and the same would apply with poster free cash flow. So I think let's move on to I guess, let's talk about an efficiencies slash capital efficiency ratio and this is one of our favorites ROIC. So I'm going to throw the four to use or Andrew.

Andrew

14:07

All right, maybe I'll give you ROIC. And I'll take it's easier, simpler cousin ROP or return on equity, whether it's basically both of these ratios, you're trying to see how efficient a company is how much profit they can generate from their assets. So in general, if we're trying to learn, we're trying to figure out how much profit can be generated from a company's assets.

It kind of makes sense that if you have assets that create buyer profits, it's going to be easier to grow because you don't have to continue building more and more assets just to get decent growth. So you take Apple as an example. They have a very high ROI E and the ROIC is ridiculous if you adjust for the fact that they just have so much cash is just sitting around. So actually makes it look less than that.

But it is. But you think about Apple, they design these phones and a lot of its software that they're updating every year and it's not require Apple to make these huge investments and assets in order to generate growth. And so a business like that can have better growth over a longer time period. And that's why you want to look for them.

Dave

15:25

Yeah, exactly. And I think both of these metrics, generally, the higher the number, the better. And again, you want to compare them to others in their industry. And they're great efficiencies slash capital intensive or capital reinvestment ratios to look at. And one of the things that you always have to consider is every business generates creates assets, that or buys assets that they use to generate profits. And the more efficiently they can use those, the more the company can grow.

And if you look at any kinds of charts or anything of that nature, you're going to see that the companies that consistently have har high ROI E's or ROI sees, are going to be better companies over the long run. One of the things that I love most about a company like Visa, for example, is the nature of their business allows them to have super high, high ROI C's, and they don't have to reinvest a lot to continue to grow because of the nature of their business. And the the I guess the more intangible part of their business. And that's one of the things that makes them the dominant company in their field is that they have so many resources because they generate so much free cash flow that they don't have to put back into the business to continue to keep growing.

They can use other they can give us dividend they can buy back shares, they can pay down any debt they have, they can reinvest in the company without having to take on debt. Those are all structural advantages that allows visa to stay. Continue to be a leader and to be nimble if they need to be you'll hear terms like this use sometimes optionality it gives them options. They have choices to make. And those are the kinds of businesses that you want to find and ROIC or ROA return on equity. Those are metrics that can help you find those businesses.

And when you're, especially when you're doing screening for good companies is, you know, look for a number that's higher. And if you look for a number that's 20 or above 25, above, chances are you'll find, you know, better companies as you go along. And the investments will impact the business and that's one of the things you were talking about the company that was you know, building those factories, and I'm guessing that probably had an impact on our ROIC.

And I was thinking about Amazon, when Amazon was expanding and building all those warehouses and everything that comes out of their free cash flow, and that impacts those or investments in the business. And no matter how great how great any businesses, they all have to invest in the business, whether it's Tesla, whether it's Nvidia, whether it's apple, they all have to invest in their business in some way, shape, or form. And the more efficiently they can do that, the better it's going to be for the long run. And that's really what we want when we're investing.

Andrew

18:21

I'm glad you brought up the low ROIC example like Amazon, because that would have been a good example of where you would probably be okay, buying a stock that has a low ROIC if you believe in its feature. Now, not to say that, like I would have invested in Amazon or anything like that, this is not my cup of tea. But I think one of the stocks in my portfolio, the ROIC is 1514 13, it's pretty low, but then the revenue growth is 11%. So what the company is doing is, they're in the restaurant business.

And they, instead of like franchise, they actually own these restaurants outright. So that takes capital investment. So as they expand that and expand the footprint of the restaurants, higher invested capital and potentially lower profits. So that's one case where I'm happy to kind of get a lower ROIC because I understand the growth picture. But for a lot of other stocks, it's kind of nice to just kind of know, hey, a lot of my portfolio has 2025 30%, ROIC.

These are businesses that are just cash flow machines, and they don't have to do that much. And shareholders we're going to see a lot more free cash flow. So that's where you get like, more dividends or more buybacks. That's all enabled because of high ROI sees.

Dave

19:52

Yeah, exactly. Another company that we both own that is kind of going through that similar thing is Texas Instruments and They are building, they're expanding their factory factory capacity to be able to build more chips. And they have been very transparent along the way of we're going to spend this money to expand our capacity and we're going to take a hit and free cash flow, our ROIC is going to go down. And these are all things that were very well orchestrated, as well as communicated. And so as investors, we knew that was coming. And you can see it in their financials. But the expectation is, is on the other side of those investments.

Once the factories are up and running, that they'll have more capacity to do more sales, and the free cash flow and the ROIC will start to rebound. And those things will all benefit investors over the long term. So one of the things to always kind of keep in mind when you're looking at these metrics is if you look at it in a short frame, and you see a number that's not so attractive, you might want to expand and look at a longer timeframe to see if that's normal for them. Or if that's out of ordinary, and if it's out of ordinary, then maybe you dig in a little bit and find out why.

And in the case of Texas Instruments, that's fine. But if you saw it in another company that was gradually going down, then that would be a sign that maybe there's something structurally going on here, that they were selling frozen pizzas, and all of a sudden, nobody wants frozen pizzas anymore. I don't know why that would happen. But LA, you know, no way. If you see something like that, then that's obviously something of concern. And something you want to keep an eye on

Andrew

21:31

100%, I'm glad you brought up the Texas Instruments example. Because I think that's a good example of getting away from the metrics a little bit. Because you don't have to understand you don't have to be like a PhD semiconductor engineer to understand that the company has communicated that they're moving to a higher surface area wafer. And so basically, what they're going to be able to do is put more of their product on the single wafer, which is like that single manufacturing process.

So logically, that makes a lot of sense, okay. They're upgrading or opening these new facilities. But it's not just growth for growth's sake, they're actually doing it so that they can have higher efficiencies, and they've communicated to me as the investor, we're expanding the actual wafer size, and that's gonna allow us to get more product out. So not only does it are they telling you that, but you can also kind of conceptually understand how that's turning into higher efficiency.

And I think it's no coincidence that they're one of those companies that continue to expand their profit margins year after year after year, because they do stuff like that all the time. It's in their DNA.

Dave

22:44

Right, exactly. Yeah, that's a fantastic, fantastic point. As you can see, we are very passionate about ROIC and Roa. And we could talk about this for at least seven or eight hours. So we're gonna move on to another one, let's talk about debt to equity. So we're, we've kind of moved from valuation to capital efficiency. And now we're going to talk about more like balance sheet strength, and kind of Quiddity issues. So let's talk about debt to equity. What what does that mean to you, from its

Andrew

23:11

most simple definition, you're looking at how much debt a company has, and you're comparing it to their assets, I think of equity as assets, because you're just taking the assets minus liabilities. But you know, if a company has 20, factories, those are all assets. If they have way too much debt compared to those, then you figure, okay, they're probably not pumping that much profit out of their factories, that could be a problem. So that's what the debt equity is trying to show, it is one of those tougher metrics, because a lot more assets are becoming intangible.

These days, people are building businesses on the internet, you know, guilty as charged. So you don't have the same kind of factories, like like you did necessarily for every business. But in the same token, there's still a lot of other things that every business needs, like cash, or accounts receivable, which is just the bills that their customers are gonna pay them in the next 90 days or whatever. Those are realities to it. But it's just a benchmark metric that helps you get better clarity about what's a company's debt picture. And you just get some apples to apples comparisons.

Because if you tell me, for example, if I pull up apple and you tell me that Apple has close to 100 billion in debt, that sounds crazy to me. But when you tell me they, by the way, have alsof 50, almost 51 billion in equity. It's like, okay, we're talking about huge numbers here. But there's logic There's reason behind these numbers, and they're not completely out of whack. That's kind of how I see that that's equity. And then I like to see how it changes over time.

So if a company's debt to equity gets worse premiere the year, the year, that could signal some problems, it could single, lots of different problems for lots of different reasons. But it's a good thing to flag and be like, Hey, maybe I need to look deeper here.

Dave

25:14

Yeah, those are all excellent explanations and nice reference to Apple, to give you a perspective, I kind of think about debt equity as a tool to examine for the company, as well as comparing it to others in their peer group, or industry. And then if you see something that's maybe out of whack, that you dig a little deeper, to find out kind of what the situation is, some industries will just naturally at carry more debt than others. And, for example, the utility industry, that sector, the way that they grow, is they take on a lot of debt. And they do that, that's one of the ways that they can grow.

And so if you look at the debt to equity of Con Ed, or any other utility, and compare that to apples, you might see something really like whoa, you know, just but that's a normal for them. And you also are going to have, you're going to have different CEOs that maybe they don't generate as much cash flow. And so they were all had debt to try to grow the business, because they're using that debt to invest in assets to grow the business. But if they have really great margins, and are able to pay their debt, then and they do that consistently, then maybe that's kind of their business model. So one of the things about that equity is, it's a really good tool to use to kind of again, help screen and find different companies.

And it's also a red flag indicator, like Andrew was mentioning, if you buy a company and their debt to equity is normally 1.2, for example, and you look at their historical average, and that's what it is, and then all of a sudden jumps up to 2.7, that might be a cause for you to raise your hand go, Hey, what's going on here. And to kind of dig into kind of what's why that is. And that's how I use debt to equity is just more of a kind of a reference tool to see kind of what's going on with the business and kind of see where they are. Because again, some businesses will use debt to fuel their business. And that may or may not be a bad thing, depending on where they are with their revenues, their margins, and other other considerations to determine whether that's good or bad. I don't know

Andrew

27:31

if this is getting too into the weeds. But when you talk about a utility company being a different business model, so they take on more debt, the banks are more willing to lend to them. Because if you think about where the utility company is, Dave has a story about this, I don't know if he wants to share, but they they they almost have a gun to your head about you have to pay and you have no other options. Similar with real estate, a lot of money that's owed to real estate owners is of the first priority that needs to be among the first priority that needs to be paid back.

So in the case of real estate, if, if that company that owns a lot of real estate goes bankrupt, at least the bank can recover the actual real estate behind it. So there, those business models, to Dave's point, just naturally have more debt than something like a technology company that might be doesn't have a gun to its head to the people who owe it money to talk about the debt to equity moving, I think, if you have a company that's piling on debt, and there doesn't seem to be a lot of return coming out of that, that probably signals a lot of problems.

But there can be good reasons to be paying down to being increasing the debt to equity, I don't want to leave that untouched either. For example, if a company has a huge cash pile, and they decided that, you know, this cash isn't earning much just sitting here, we're gonna give a lot of it back to shareholders, because we have plenty of cash as it is. That's where you can see that equity start to rise. And that would not be concerning to me. But if I saw that increasing, just to buy back shares, Starbucks, then that would be more concerning. So it is you do have to take kind of on a case by case. But in general, it's probably a decent rule of thumb that if it's increasing, you want to be careful.

Dave

29:26

Those are very good points. Let's move on to interest coverage. This is the fifth and final metric, or ratio, we feel like every investor should know. So what is interest coverage? And what does that tell us?

Andrew

29:42

So we're looking at a company's profits and we're looking at what's the interest they pay on their debt, and we're just seeing how much how much are they covering it? So in general, an interest coverage ratio. Call it Rena half, four. Is is good. And anything below that, you might start to be worried about the company. So what the interest coverage ratio looks at is the operating profits, also known as EBIT or earnings before interest in taxes. And then you're dividing the interest paid for the year the interest expense on the debt.

And so that number gives you a point of view, if I have $100, in operating income, operating earnings, and $10, in interest coverage, I have 10 times 100 divided by 10 out of 10 times interest coverage, so they could pay for that interest. 10 times over, that's pretty safe. And that's kind of the general idea behind it.

Dave

30:48

Yeah, it's a liquidity ratio, it's something you can use to tell you how liquid the businesses, and to Andrew's point, how well can in essence, manage its debts, its bills, maybe that's a better way of putting it. And the higher, the better. And there had been a few companies that I've looked at that their interest coverage was less than one. And during the pandemic, when they struggled to generate revenue, it put them in a bind, they were able to get get through it. But you know, it was scary for a couple of them during that period. And that's why, and that's where, when you have a company, if you use this with like, looking at the debt of the business, this is where these two, like a debt to equity and interest coverage can kind of work together.

Because if you see a higher debt to equity, and then you also see a lower interest coverage, that could be a sign of problems to come, it doesn't necessarily mean today, something good, bad happens. But if a black swan event happens, like a pandemic, or some other unforeseen incident comes up that the company all of a sudden loses the ability to generate profits, then it could be in trouble of defaulting on their loans. And that's how you go bankrupt. And so that's why looking at this kind of metric is very important to understand, you know, because most companies, the very few companies don't carry any sort of debt. And most of them carry some level of debt in one way, shape, or form.

And so understanding what their interest coverage is and how well they can manage that ability to, to pay that it also will go a long ways to tell you how profitable the business is. But it also will tell you if they ever need to take on debt to try to fund a project. Because they want to use their cash for another reason, if they have a really low interest coverage that would maybe prevent them from being able to get the debt that they want to use. And so that could prevent them from growing.

And so that's another reason why kind of understanding the interest coverage, and have an impact on your investments and why you should be cognizant of what your company's interest coverage is doesn't mean you have to watch it daily. But look at it every six months and just kind of make sure and when you're screening for companies like Andrew said, try to find something above three and a half to four. And if you can find that, then that's that's a good safe place to start,

Andrew

33:06

you know, areas where a low interest coverage ratio might be okay, one that kind of pops to mind would be if a company temporarily has one bad year, let's say or the company tends to have a slowdown during a recession. And so for one year, because the profits are lower, the interest coverage ratio is higher, I probably wouldn't worry about that. But today's point is somewhat of a liquidity ratio.

Because if they have that happen to them, and they have no backup cash that can be accessed to be very, very problematic. So there are some exceptions to the rule, just like any rule or any metric. But there are also reasons for wanting to be diligent with these metrics is because stocks, businesses, they do well. Until one day they don't. And if you're not actively trying to avoid those scenarios, then you're gonna get wrapped up in probably too many that you care to be in.

Dave

34:14

Yep, I totally agree. All right, everyone, that is going to wrap up our 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 our show. And don't forget to browse the incredible materials we've created for you at E investing for beginners.com.

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