IFB295: Validity of Scuttlebutt + Quantitative Analysis

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Dave

0:00

Alright folks, welcome to Investing for Beginners podcast today we have episode 295. Today we're going to talk about the validity of scuttlebutt and the importance of qualitative analysis. And Andrew and I thought this would be an interesting topic to talk about, because it kind of gets away from the numbers and the focus on the numbers, and talks about maybe some of the more air quote, soft skills of investing. So, Sir Andrew, I'm going to turn it over to you to get us started. And then we'll go ahead and chat a little bit.

Andrew

0:30

This should be fun. We were looking back in the archives, and this was an episode we did in Episode 12. And I mean, I feel like my thoughts have evolved on this. And, you know, my approach has evolved as well, since those very early days. So hopefully, we can give a slightly wiser and still viable discussion here. So how would you define scuttlebutt and qualitative analysis? Okay,

Dave

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so I guess the way I guess I would define it is scuttlebutt would be information that you learn from sources outside of the financials of the business. So it's information that you maybe you pick up on the street information that you hear in the news information you hear from company employees, that's I guess how I would kind of define scuttlebutt, you could probably put the whole rumor mill Haig on it, or gossip, if you want. I think I've heard somebody talk about that, in respect to scuttlebutt. And I guess that's kind of how I would define it.

As far as qualitative analysis. To me that really implies more soft skills, where you're thinking more about management, where you're thinking about management's impact on the business, and you're also thinking about the moat, or the competitive advantages, any potential growth or decreases that the company could see, and how those all impact the investments. So it's more about, I guess, using my noggin, and thinking about the business trying to think about a little more deeply outside of reading about their capital allocation skills or something of that nature. So how about you? How do you when you think of scuttlebutt or qualitative analysis, what comes to mind for you?

Andrew

2:19

Well, I'll give you the latest scuttlebutt I heard, which actually, I shared with you previously, so it's not as funny to you. So sorry for that. But I was I had heard somebody just walking by randomly I heard them say, Costco will never let you down. Yeah. And yeah, I wonder if like, kind of random things like that, you can use that as usefulness not to say, oh, my gosh, I heard that stranger on the street, say something, and that's gonna make me buy a stock. But I think with different companies, you can kind of take the temperature of where things are, and little things like that. And maybe go a long way towards confirming the way you feel about the company. Or maybe if you felt suspicious about the company, and then you got hair in your pizza or something when you went there, maybe that can be a signal to it's not a crazy concept. It might sound crazy at first, but either Lynch's talked about knowing what you own.

He talked about how he went to a store with his wife and saw the line and it gave him an idea to research this company. So it's not something that you throw out the research completely. But it can be a useful signal, I think, in kind of prompting you to think maybe a different way about company, or big, a little bit deeper in a way you feel about a company. And I think if it can encourage you to learn more than it's, it's worthwhile.

Dave

3:42

Yeah, totally, it totally is. And that kind of idea is something that I don't think is talked enough about, I guess it comes back to trying to be observant of your own orbit, what's going on in your world. For example, my fiance isn't like this, but I've heard people talk about how their significant other, you know, lives and dies by whoo lemon, for example. And they just they buy everything, and anytime something new comes out, they go there to the store to get it or if they need something, to go to a show or something. They go to that store, you know, those kinds of things, or my ex wife lived and died by Starbucks, it would just he had to have it every single day. And she was grouchy anyway, but he always wanted to get it.

You know, she said that she had to get it because that was part of her routine and whatnot. And she lived and died by Starbucks. And so I think those little subtle clues can certainly tell you, you how important those businesses are to people and maybe give you insight into what kind of competitive advantage they may have. Because if they're driving that kind of fan devotion, or particular things, it might be something worthwhile to look into. And to determine, you know, if this is really, you know, something I got to have, you know, like the whole iPhone thing, you know, there's people that I was reading few days ago, one of the an NBA player had to go buy an iPhone, because the rest of the team wouldn't let him in on the group chat, because he had a Samsung phone. You know, and so that tells you that, you know, Apple has a strong presence and the culture of that the team.

And so they're fans. And that's something that you want to think about when you're trying to think about, you know, how important is this business and what drives growth for this business. And you begin, create fans like that, that helps spread the word for the business. And those are all things that go a long ways towards the company being successful.

Andrew

5:35

So my neck of the woods, we're building all over the place, but one of these new fancy has a movie theater has like trendy ice cream shops, all this really nice stuff. The trendiest like rooftop bar and all this other brand new Lululemon opened up right there, next to the Nike store. And so, you know, I didn't hear it, but you can go out in person and see these things. And you wonder if that gives you a little more information than looking at a financial statement and saying, oh, yeah, this company open the store and this company, open the store. But you know, it could be two very different stores two very different signals, depending on the context. And I wonder if that's, those are little things like to your point, it's not talked about a lot, but Who's stopping you from going in and kind of thoughtfully observing your surroundings and looking at those kinds of things, I probably don't do it enough, I

Dave

6:27

know, I don't do it enough. And sometimes I kind of kicked myself like, My daughter loves Chick fil A. And so every time we go there, I just observed the lines, it's a well oiled machine. So it goes quickly. But when you look at it, you're like, you're gonna be here for 45 minutes, and they just kind of zip through. But you think about that's obviously, a brand that has created a loyal following. And it's something that you know, a lot of people love, and that's, those are little things that you can pick up, like, I've been driving across the country a lot recently. And I've been noticing a lot of Old Dominion trucks. And so that's something that just, you know, I see the logo on the side of the truck, and it sticks with the or prime, I still audit prime trucks.

And so those are all things that, you know, I observe out in the wild, if you will, and it can give you an idea that, hey, maybe if I'm seeing all these trucks everywhere, then that indicates that the business is doing something. And so maybe I should look into it, sometimes it may not pan out for whatever reason. But I think it's a great way to determine maybe qualitatively how strong a business is by just the reaction to the public. of, you know, when a new rule Emin opens up, or, you know, a new Chick fil A opens up in an area, those are popular places, it really kind of shows how strong their brands are,

Andrew

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to take the other side of that. I mean, I don't invest in McDonald's, I never have their numbers don't appeal to me at this time. If I was a long term, McDonald's, shareholder, and I don't know what their numbers are now. So don't take this the wrong way. If you own McDonald's, I know they've been a great stock for a long time. But let's say you saw that same store sales and McDonald's was down, or it's really slow growth. And you listen to the company and management saying, yeah, it's the economy, its interest rate, its inflation. That could be the case. But if you're to your point, looking at like a Chick fil A drive thru, and then if there's a McDonald's half a mile down the street, and the drive thru lengths are so much different. Maybe you want to question what management's saying, and what their excuses are for why the numbers don't look great. And that that's another I think, example of kind of take the negative approach of it, of using scuttlebutt to or IFP version of scuttlebutt today, to use that to kind of think about your investments.

So I feel like we should also bring up myopic circles while we're talking about scuttlebutt, because there is a way to take this global idea too far. So can you explain myopic circles and No, no, I'll explain it. If you want, like a good definition, listen to our episode with Vitaly, he is a fund manager. We've had them on several times, and great guy, great conversations, and he's defined myopic circles. But he basically says, His example is that him none of his friends smoke. And so he kind of thinks it seems to him like most of the world doesn't smoke. But there's actually a big portion of people who do. So we get in these kinds of bubbles, where we hang out with people like us, and we might not get exposed to everything that's in the world. And so you can take this myopic circles thing a little too far.

To go back to my McDonald's example, there could just be one bad franchise owner in some random city that you happen to be at, where they've put hair and their fruit every day for the last three years. And maybe that's why that McDonald's is not doing as well as Chick fil A but maybe if you expand your horizons looked across the country That wasn't the case. So you do want to be careful about taking scuttlebutt too far. And especially because myopic circles are tough because we don't realize what myopic circles we're in. Because because we just have that we have our own bubble. So you do have to be very, very careful. I think that's where going back to the numbers again, helps, because the numbers can check the scuttlebutt, and the scuttlebutt can check the numbers and the qualitative can check the quantitative and the qualitative can check the qualitative. So I really see those as going hand in hand. And I think the better that investors can get at balancing that the better decisions they can make over the long term.

Dave

10:38

Yeah, that's a great point. I love now that you're talking about it, I do remember a conversation with Vitaly about that I was having a, an old age moment, if you will. I mean, that's a fantastic point, is that we get wrapped up in our own little bubbles. And we think that nobody smokes, when in fact, a lot of people smoke. I mean, you know, in my own personal orbit, nobody smokes. But when I worked in the restaurant business, everybody smoked, except me. And so you could take that two ways, you could think that everybody in the world smokes, because in the restaurant business, most people do. But in my circle, nobody does.

So it's interesting how you can get yourself into a bubble and think that everything is like that. And I think kind of thinking about that. What would be some ways that investors could maybe try to help themselves kind of expand their bubble? Or offer alternative versions of their bubble, if you will?

Andrew

11:27

That's a good one. One that actually is related to our conversation today is the scuttlebutt idea was originally, that name was created by Phil Fisher. He's written one of the investment classics, common to common stocks and uncommon, was it

Dave

11:43

uncommon profits within comics, I think it's the other way around. I think it's common stocks and uncommon profits. Yeah, there

Andrew

11:48

you go. So Warren Buffett shouted out that guy, and he's a great investor in his own right, he's talked about when you do scuttlebutt, you would think that you would, you would want to talk to the CEO of the company whose stock you want to buy. And he says, actually, probably the better ideas come from talking to a competitor and asking that competitor, hey, which company in your industry keeps you up at night? And if they say in the company that you're thinking of investing in, then that could be a good signal? So to answer your question, Dave, one way that you can expand that myopic circle is when you're looking at, if I feel a certain way about Domino's, instead of just looking only at Domino's, let me look at what Papa John's is doing. Let me look at what Little Caesars is doing.

And you try to get the entire industries viewpoint helps give you a lot of context. And then if you can move up and down the value chain to look at the food distributors that are providing ingredients. Look at what customers are doing other like b2b business. And as you want to look at the business below them, those things give you really help you paint that picture, where if you just only focus on a single company, and only get the viewpoint from that company and that management, that myopic circles is really limited. Instead, try to look at all the pieces around.

Dave

13:07

That's a fantastic idea. And I think that's something that I know I've tried to incorporate in my research of companies is looking at the other businesses in their orbit, to kind of get a sense of kind of where Company A sits in this particular industry, because it can be very, very helpful. And sometimes you even find better opportunities than the one you're actually looking at can also kind of help, like you said, kind of help hamper your your bubble. And not think that this is the greatest thing since sliced bread and all these other ones are not where you may find out that it's actually the reverse. And that can be very, very helpful. Another thing that kind of came to me too, as I read, I'm not sure I don't remember where I read this.

But be a little bit when you're listening to a CEO talk, for example, in an earnings call or another, they're being interviewed, one of the things you always want to kind of keep in the back of your mind is these people are salesmen. Their job is to build up the business, build them up, pump them up. And most of them are charismatic, most of them are outgoing, very well spoken, well dressed, you know, you like them. That's natural, that's but they're and they're leaders and you like them. But you also have to temper a little bit of what they're saying. Not that they're telling you lies, but that they're positioning themselves in their words, to try to influence you. And that's why I think some of these guys especially Buffett, do not spend a lot of time talking to the management of the businesses because they don't want to get influenced by their charisma, for example. I mean, that's part of the charm of Elon Musk.

He's very charismatic, you know, love him or hate him. He's very charismatic. And there's other people like that Jamie Dimon from JP Morgan I love him and he's but he's very charismatic and to sit down and have dinner with him would be an amazing but If I had to talk to him about his company, he would definitely will try to sway me from looking at US Bank or Bank of America, for example, he just, he wouldn't talk badly about them. But just he would be so enthusiastic about JP Morgan that it would be hard for you to see behind the kind of past that glare kind of thing. So when you're listening to management talk, or you're thinking about management, always kind of keep that in the back of your mind that their job is to be charismatic and a salesperson, and that you just kind of have to dial down the enthusiasm for them. Because it's, it may not always be in your best interest to invest in the company, even though you liked the CEO a lot.

Andrew

15:37

Write that one down. That's some wisdom. Right? So any other ways you think investors can think about expanding the myopic circle, I think

Dave

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there's a few things kind of scattered thoughts that went through my head. Number one, I was talking to somebody. And they were telling me that one of the things that they do, to try to give them a sense of the business, they actually go to the business and talk to employees. So they don't talk to the management, they talk to the employees. So for example, if you go to Costco, and you're checking out at Costco, ask the cashier, what do they think of working here? What's your favorite thing about working here, that kind of thing. They'll ask them these kinds of questions to kind of get the feedback from the employee of what people think about that. And other thing that that I've heard, is people will stand outside of a store, and watch how many people go in and what they come out with. Like, if somebody goes into a clothing store, you see a lot of people going in, but not coming out with many clothes.

I mean, that could lead you to think okay, this about this company, what not, if you do that with all their competitors, like if you go to a shopping, if you go to a mall, it's very easy to go from store, to store to store to store and just check out the behavior of the customers in those particular stores. And that's information that can help you, it can confirm or deny how great or how not great a particular company could be just by the customer behavior, for example. So those are, I guess, a couple of ideas that I've, I've heard through the years, that can be useful to help not only expand your horizons, but I guess burst your bubble a little bit and also kind of break the myopic bubble. If you're super, super into Target. And you go to Macy's, Walmart and Lululemon and the limited, you're gonna get vastly different kinds of reactions from the customers as well as the employees. And those can go a long ways to giving you insight into the company.

Andrew

17:29

That's yeah, it's those are all excellent ideas. I don't remember if it's as Damodaran or if it was Vitaly, but I think it was, it was Dominador. And I think he was, and by the way, this guy is the professor of valuation, which means he teaches you how to smartly how to figure out how much a company's worth for a living. And I think he said one of his tasks was to figure out the valuation for Uber. And so he took an Uber and just talk to the driver. Actually think he called his son first. Yeah, call me an Uber. And he's like, What do you mean, Uber? Like, he didn't know what that was, you know, he's

Dave

18:08

like, I don't know what the super saying is

Andrew

18:11

a great example of taking that idea. And apparently, Dumbledore was saying he learned so much about Ubers business, just from talking to the Uber driver is Uber, Uber drivers, a contractor, they're running their own business inside of Uber, obviously. So you can learn a lot. I think that's something you do really well, Dave, is you're able to reach out to people, you know, have expertise and get information about the concept. And I wonder if that's something that more investors can do?

Dave

18:37

Yeah, I mean, they certainly can. And the biggest thing is being open to asking questions, and being open to asking me or making yourself look like you don't know what you're talking about, but you don't. And so that's why you're asking questions is you're trying to learn something and being okay with that 99.95% of people are going to be totally fine with that, because you're coming to them. And it makes them feel important and feel like they have knowledge and they do and you're trying to you're trying to gain that knowledge from them so that you can learn something about different concept or different businesses and whatnot.

And yeah, I love that story about the motor and their Dumbledore and I thought that was kind of brilliant. That was kind of funny, because the way he phrased it was like he'd never heard of the company had no idea what his son was talking about. And I think the company was getting ready to IPO and or go public. And so he wanted to learn more about it. And that he said, I think he said that he got more information from the Uber driver than he did from the s one or any conference call, just just by talking to the Uber driver for half an hour. You know, I think kind of think about it kind of along the lines of talking to employees.

A lot of times you're gonna get the unvarnished truth from them. You know, you're gonna get the book, the good and the bad. Sometimes you'll run into the people that are just, you know, they've drunk the Kool Aid, and they're just going to give you platitudes, but a lot of times you'll run into people that will tell you the truth, and especially if it's an environment They feel like they can talk. You know, if you're at a party with somebody and you're talking to somebody you find out they work at Target, for example, you can ask them questions about target, what's it like working there? What is the management? Like? How do they treat you? You know, how long have you worked there? What are their working conditions?

Like all these things you can ask them? You know, and of course, have a conversation that can help, you know, tack on your scuttlebutt, I'm not saying you get to go to a party and like, do work at Target, do you work at Target, but you know, those are kinds of situations where the employee is going to be far more open than maybe they would at the store just because they're afraid, Big Brother's watching. But if they're out at a party, or they're, you know, on a, at a park or something, and whatnot, you know, the opportunity is a lot easier in those circumstances.

Andrew

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Any other ways that investors? The average investor can pick up Skoll? But yeah, there's

Dave

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probably two more, I guess, formal ways, if you will, that without having to rely on your social skills can give you some insight into maybe the goings on in a business. And one of them is a website called Glassdoor. And this is a an employee and employee rating system, if you will, that allows you to, for free, see what employees are saying about working at a company, what they think of the CEO, for example, what are the working conditions? Would they recommend working at this business? Do they recommend it to their friends kind of thing. And those are all things that can give you kind of a snapshot of what employees think about working at Target. Again, I'll just use that as a common theme here.

And that can help you get an insight into the company without actually having to go to talk to employees and stuff. And a lot of times, they will tell you what the culture is like, you can read employee reviews in Glassdoor. And they'll tell you, you know, what they think of management, the culture, what they think of the company and whatnot. And this is a tip that we picked up from Todd, Todd winning, he works ensemble capital, and we had him on the show a while back. And this is something that he suggested was using Glassdoor as as an insight into culture of the business. And so that can be very helpful, especially if it's a company. If you live in Iowa, and you want to investigate a company that's in the Netherlands, it may be harder to go visit the company and another one's kind of thing. So that can be very useful. The other tool that I haven't used much personally, but I think can provide a lot of insight into the business beyond the financials is services like Pekus, which are professional investment services that they interview, former or current employees of different businesses, generally, they're in management, some level of management, or higher positions of authority.

And those can give you insight into the culture or the goings on with the direction of the business and those kinds of things. And that can be you know, a more formalized, it's about about if you will, and that can be very helpful. If you can find those kind of services, they are a bit pricey. So it's not something that the average everyday person can use. But I know that there's a lot of professional investors that really like those services. Patrick O'Shaughnessy, in particular is a big fan of that stuff.

Andrew

23:11

So there any, you know, we talked about you want to mix the quantitative with the qualitative, so don't rely only on Scott all but make sure you confirm your thesis with numbers. Any other downsides, things to avoid when we talk about this whole scuttlebutt conversation? Yeah,

Dave

23:31

I think the number one thing that pops into my mind is insider trading. And that's something that you, you want to avoid at all costs. It's not worth whatever you could make from it. Basically, what insider trading is, is that you buy a stock based on knowledge that you gained, that the public has no access to. So let's just throw out a hypothetical. Let's say you work at a company, and the company discovers the secret to making you never hungry again, by eating this one little thing. And then you go out and you buy, you borrow and beg and get as much money as you can to invest in this company. Because you know, that once that product goes on the market, it's going to revolutionize food, and diets and health, everything anyway.

So you go and do all that. And then the company comes public with this knowledge of this information, they start selling the product, and then the stock goes to the moon, of course. And then the government finds out that you heard this information from your best friend across the street, who was the CEO of the company, and he told you this in confidence, and then you went out and bought it. And the rest of the neighborhood had no knowledge of this information and couldn't. That's insider trading, and you can go to jail and pay a lot of money for doing this and this is verboten.

Don't do it. So whenever you're Let's say you are talking to an employee or you're reading a transcript that's about an employee that used to work at the business credit lately on how, how much you act on that information, or at least let time go by, before you pull the trigger, it's one thing to know, it's another thing to buy before, it's public knowledge. So if you aren't something that's insider information, and then six months later, it becomes public knowledge, and then you buy the company, that's totally okay. It's the six months before it becomes public knowledge, that's the gray area, you don't want to go into gray area. And so that's one of the not a downside to scuttlebutt or qualitative analysis, but it's something you have to to know. And keep in mind, in case you are privy to private information that other people don't have. And if you go talk to an employee at Target again, and they tell you, they don't like working there, that's okay. That's, that's one thing. But if you learn something that's, you know, insider information that can be very valuable, then you're gonna have to sit on it, you just gotta it's not worth the the pain and effort.

Andrew

26:04

For sure. Well, thanks for explaining that for everybody. I hope they found a discussion on Scala interesting, then, I liked the different ideas you had on expanding your circle and doing some of that. So hopefully, people find it valuable.

Dave

26:18

Yeah, me too. I think this conversation is an interesting conversation. And I think it can be very helpful for people and for those people that aren't super super big into numbers. This could be a way to kind of break into investing as they join it the softer skills of learning about a company and then they can add, you know, the hard skills of you know, figuring out what an income statement is, and so on. Perfect. All right, everyone. Well, that's gonna wrap up the show for this weekend. Don't forget to subscribe to our show on your preferred podcast app if you enjoyed our little show. If you would kindly consider giving us a review a greatly helps our show.

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