IFB301: Capital Allocation: The Number One Job for CEOs and Its Impact on Investing Performance

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Dave

0:00

Alright folks, welcome to Investing for Beginners Podcast. Today we have episode 301. Today we are going to answer three fantastic listener questions we got. So without any further ado, let's go ahead and dive right in. So we got first question. This is a two parter. So first time caller, new listener, very funny love the podcasts and all the information you're giving the public on investing.

Question number one, should I trust the financial websites, Yahoo, financial or whichever you prefer? When it comes to figuring out ratios like P E ratio, earnings per share, EPS, market cap, etc? Or should I figure it out myself? I appreciate you giving the formulas to figure out these on my own. But now I'm paranoid and wonder if I should be trusting these websites lol. So great question. And I guess what are your thoughts on this

Andrew

0:45

is a great question. And thanks for writing in, or I guess Pauline in this case, I think depends on what you're trying to do. So I guess if I was an investor, and I didn't, I was looking at what the metrics were on the website, but I didn't really know what they meant. That would be a problem to me. Like, I feel like the value in knowing how to calculate something is that you understand what it means. I mean, I hate to call it like being in school again.

But unless you've kind of like done the homework, sometimes that's the only way you know how to solve a math problems because you've done it before. So if you don't necessarily know how to calculate a price earnings ratio, a P E ratio, for example, then are you really going to understand the difference between a 15 or 20? P? I don't know. It's that's kind of the way I look at it, do you have a different way?

Dave

1:40

No, I think the first thing is you need to figure out what's inside the recipe, if you will, when you're making food, you have to kind of decipher what's in the recipe and are the things in there that I can't or can't eat. So for example, I'm a type two diabetic. So I need to avoid carbs and sugar. So whenever I pick up a, something to make bacon, for example, I look at the back of the label to make sure that there's nothing in there that I can't eat, because sometimes it may be maple bacon, and they put a lot of sugar in there, and then they can't eat it.

So I guess really understanding what it is you're cooking with, I think is the first thing so really understanding what a P E ratio is and how to determine it big reason why we spend a lot of time talking about those metrics and kind of going over them. So people understand how to calculate them, so that they can do it for themselves. Because a lot of the times, you don't see the P E ratio and a company's 10k, that's more something that's either calculated on your own or it's something that they'll see on the financial websites like Yahoo, financial or stratosphere, I guess, as far as like crossing them, I have found that the majority of them are really good and pretty consistent on earnings per share. P E ratio market cap, I think those are pretty generic, I don't think you'll see a whole lot of variation between those, the one that really trips a lot of people up is return on invested capital. And we've talked about that a lot.

But that one, if you look at five different financial websites, you'll see five different numbers. And it's all because they all calculated differently. And there's a lot of different ways to do it. So that one in particular, I always try to calculate it myself, Andrew and I have created this great spreadsheet that has a calculator that we can do it ourselves that way and it works really, really well. And so that's something that I prefer to do that. But the P E ratio, I'm perfectly fine unless it seems really, really out of whack for the financial upside. But I found that those are pretty consistent. What are your thoughts on that?

Andrew

3:35

Yeah, the PE actually is tricky, because we can have a forward PE or trailing PE. A lot of websites do differentiate between the two, though. So I think Seeking Alpha a show what the forward PE is right. And all

that's telling you is what the analysts think the earnings will be versus what the earnings actually are. So you do have to be cognizant of that.

But to Dave's point, I completely agree that I wouldn't worry about trusting websites like this as long as they're a reputable one that you're comfortable with. Because, yeah, a lot of the numbers are not subjective. I mean, ROIC is one that is, but the rest of them are pretty basic. And you'll find that they're pretty consistent. So as far as trusting them, I would have no problem trusting them.

Dave

4:25

Right? Yeah, for me, too. I think one of the things to also keep in mind when you're thinking about something like a ratio, for example, I wouldn't get too wrapped up in if Pepsi is trading at a 15 pe versus a 17. Pe, you know, if you see 15 on one website and a 17 or another, I wouldn't get too excited about that. Because if you're making an investment decision based on one website, saying it's lower than the other, then I think you need to probably think through your process a little bit more because that little variation is not going to make that big of a difference in the grand scheme of things.

And there's a whole lot of other things you need to think about before you use something like that to just make an investment decision. If you're using a first screener, you know, trying to find investment ideas, you know, that's again, I guess I wouldn't get too excited if it's a 20 pe versus a 30. If it's a 20 versus a 45, okay, then I may need to sit down and figure this out. But if it's a couple of numbers off, I wouldn't get too excited price to free free cash flow any of those numbers. I don't think I would get too excited about that, more about comparing that to the actual financials. And then if you really are digging in, then you can start kind of putting the numbers together yourself. I guess that's one of the ways I try to kind of work around that, I

Andrew

5:41

guess. Yeah, well said. All right.

Dave

5:44

So let's move on to the next question. So we have question number two, I have read slash wisdom through audible, the intelligent investor, I will definitely have to read it a few more times to understand it more. It was a great first book to read on investing. Can you give me a list of books to read next in order of basic slash

intermediate slash, advanced level of understanding? I bought Andrew SEVEN, SEVEN book also, which was a great read as well. If you've answered these questions in the past episodes that I apologize, I recently started listening, and I'm only on Marta 2023 episodes, keep up the great work. Apologies accepted and no problem. We're happy to answer this question again.

Andrew

6:23

I'm going to answer this question a little bit differently, because I feel like I've been saying the same thing for five years. So I must switch it up. Because that's not you get different nuggets from different books. You know, it's not like a secret recipe and five books will make you a great investor. It's really a, like learning a language. It's a long term game. So I mean, ideally, you would read more than just five over your investing career. Right? So I guess I'll start with one kind of more on the beginner side, I really like should make this into a genre one day like, you go to the bookstore and you have romance, you have horror, and then you have investing. I don't know how you would call it but just like, whenever they interview, big groups of investors.

So William Green did this in his book. There's been a ton of different books like this, but just getting people who sit down with other investors and asking them, Hey, what did you do that worked really well, right. So I want to pull one out of the out of my obscure, dusted off here. The basement of investing Tomes, this one is called investment gurus by Peter Tanis. And that was published in 1997. But to me that feels like the 80s. So it's really great. It's just another one of those books where you get insights from a lot of different investors who have done well.

And you can see where there's places where people have similar strategies, like a lot of successful investors will hold a stock for a very long time. So you get a lot of similarities, but then you also start to see how there's a lot of different ways to beat the market to. And I think by getting a variety of viewpoints, I think that's great for beginner, and a lot of times when it's an interview format like this, it can be beginner enough, because it's almost like listen to a podcast, if there's going to be complex topics, they usually warm the audience into it. I like to investment gurus, because I've had a lot of great nuggets from a lot of really good investors. That's awesome. I've not

Dave

8:25

read that book. So I'm gonna put that on my list of books to read.

Andrew

8:28

So that's cool. If you can find it, the 97th edition, good luck. Well, I

Dave

8:32

know somebody who has it that I can follow it from intent. Tomorrow, number one, for me is going to be psychology of money. And this is from Morgan Housel. And I think this is a great book to really get you started with the whole idea of investing and how you can think about money, and how to start budgeting, how to start investing, and just kind of think through really what it is what your what your end goal to be when you start investing. And you know, beyond just I want to make more money, and really kind of putting some thought into what your plan is going to be and how you want to start executing on that plan.

And Morgan has a really great easy way of writing is one of the masters of intertwining stories among dropping lots of nuggets of knowledge and information. And it's such an easy book to read. And I've read it several times, and I have it all marked up. It's one of the few books that I actually did mark up. I always feel like that's kind of sacrilege, but I'm from a different era. So I think it's a great first book to start as a beginner.

Andrew

9:35

I agree. Yeah. And there's a lot of great personal finance stuff in there too. Yeah. So another one that I just started picking up and reading. So I've only read like two or three chapter. So take that for what it's worth, but it seems good so far. It's called Market Masters by Robin speziale. And it's actually interviews with Canada's top investors. So yeah, it's really interesting. I read a couple about kind of like gar But which is grown at a reasonable price.

And I thought those guys are really brilliant. And so it's a good book so far, and I would recommend picking it up. And that's also more on that beginner side. But it's advanced enough to keep me interested. So that's a lot of books actually are like that still. So that's a great thing about reading about investing. Yeah, for sure.

Dave

10:21

Yeah, that sounds like a great book. Again, another one I have not read. But when I think Hint, hint, wink wink, I know who somebody I could borrow it from.

Andrew

10:28

I'll take extra notes then on these copies, okay, because I scribble all over mine.

Dave

10:35

The next one I have is richer, wiser and happier. And this is from Liam green. We've been lucky enough to have Liam on our show a couple times. And brilliant guy, fantastic writer. And he interviewed some of the top investors in history, and just kind of shares all of their insights. Mohnish pabrai, Charlie Munger, Joel Greenblatt on gainer, just on and on and on the Illuminati, if you will, of investing, he's been lucky enough to share rooms with and talk to them about their ideas and how they improved and it doesn't just talk about, you know, hey, you need to go out and find these kinds of companies to invest. It's, it's about a philosophy of investing and how you can kind of balance that with having a life. And just that money is not the ultimate driver of happiness.

And because some of these people are the wealthiest people in the world, and that didn't make them happy. It was other things in their lives that made them happy. And he just has a great way of, again, kind of sprinkling in all these great stories among all this wisdom that he's dropping, and it's a really good book for kind of getting your psychology of how you want to start investing and keeping a guide of where you want to go, just like Morgan Housel is book and it's more about the psychology of investing, as opposed to the nuts and bolts of you know, hear do this and hear do that. And it's it's great to hear guys like Mohnish pabrai talk about their story. And you know how they got where they are. That's fantastic. Oh, yeah,

Andrew

11:58

I guess I'll shout out another guy we've had on our show before Vitaly katznelson. He has a book called The Little Book of sideways markets. And that one's really great. I mean, so many of the little books in that little book series are really good reads. This one in particular, wouldn't say it's necessarily not for beginners, because there's a lot of good chapters in there that I feel like anybody could read whether you have a background in this or not.

But there are this chapter of it marked up it's like page starting on page 46. They have Vitaly breaks down this, the basics of DCs, and explains it in a really thoughtful and easy way. I know financial formulas can be

really intimidating, especially a DCF. But he used a story with a donkey or something like that. And that, that really helps to get me around the concept of DCFS. For the very first time, it does take a while to eventually master that. But it does definitely a good intro into DCFS.

Dave

12:58

It's a fantastic book. And he is a wonderful, wonderful writer, big fan of Italys. My third book, I chose the Dondo investors. I've recommended this book before, but I really liked the written by maujpur Bri and I really like the way that Manish writes the book and the way that he presents the material in there. And he does start to kind of delve into financial concepts. But he does it in a way that he explains it using more abstract ideas and kind of condensing everything to make it more logical. And so instead of it being a textbook and going, you know, here, do this and do this and do this, like an accounting book, he more uses stories of different companies and different situations and kind of weaves it all in to an idea, this is how you do it.

And as the you know, the main gist of the book is trying to find companies that you can invest in that you have a lot of potential to make money. But if it doesn't go well, because not all investments will go well you don't lose that much. And so the phrase in the book is heads, I win tails, I don't lose that much. And it's kind of the basic theme throughout the book. And it's a really easy read just like the other two that I mentioned. And it doesn't bog you down with a whole lot of numbers. But it does start kind of introducing these concepts of finance and how that really works in the investing world. And I think it's a fantastic, really easy intro kind of intermediate book to get into the heavy stuff.

Andrew

14:21

Nice. The next one, a book called more than you know, by Michael Madison, and a book like this and almost opened up a whole entire world to you because then you start to see other kind of bigger picture ways that you can approach investing. So I don't want to minimize what's in there because there's so many different profound ideas. I'm obviousness thrown in this book. But just as an example, the idea of how luck can play a role with investing Davy roll about you run a great post about this recently on the blog, just this whole luck versus skill.

So the game of baseball, me and Dave are big fans of baseball, as well. a lot more locking in than the game of basketball, which I'm also a big fan of where a guy is going to make a jump shot most of the time, whereas the baseball can bounce anywhere. And so with investing, and just the business world, even in general, you get a lot of that randomness, too. And so to be a good investor over a long period of time, you

have to understand how to deal with that reality of the stock market. And to kind of take those next level thoughts of how can I behaviorally become more aware of myself and my biases?

And how I think, and how can I take control of that, and become a better investor? I mean, there's a whole other side of, I guess you'd call it what, like behavioral psychology, yeah, that you can really go down that path. But it's very, very helpful. Because if you can get your emotions in check, if you can remove all of the biases that all of us have, you're just going to become a better investor. And this book is a great way to start to think in that way.

Dave

16:01

I love that book. And Mobizen is one of the best at explaining those concepts and putting it in words that, you know, us mere mortals can understand. And he just has a great teaching style. He's just very clear on how he explains things. Big fan. And yeah, the whole walk and skill thing is something that I think a lot of people haven't really thought deeply about, and Michael has, and he shares all those ideas with it. And it could definitely make you a better investor. So yeah, big fan.

Andrew

16:28

I don't know if anybody's thought as deeply as he as

Dave

16:30

knew. I know, I haven't. I know I have it. So my next book is going to be going back to the woudl book series. And this is the little book evaluation. And this is by one of my favorites. Professor Oswald the motor. And and this is probably, I think, one of the best books, introducing the whole concept of valuing company. And when we talk about valuing a company, we're not talking about what is what price it's selling for, we're trying to determine, what is the company worth, it's like buying a car, you have to figure out what is a stock, what is Pepsi or Coca Cola worth before we invest in it.

And he is I think he plays. He's the Dean evaluation. He's taught it for many, many, many years. And he's just very clear, very concise, and he has a great way of putting complicated topics in a way that everybody can understand them. And this book, in particular, I think it does a really, really good job of explaining a complicated process, like a discounted cash flow model, or any other more intricate finance concepts, and

explaining them in a way that I think is a really good introduction before you get into heavier books that really focus on the whole valuation concept, because it can be a pretty heavy subject once you really dig into it. What's your last book?

Andrew

17:48

I mean, I have to pick one. No, you don't. I guess the ultimate would be security analysis, which just thinking about that I should probably do a refresh on but that was a book by Benjamin Graham. And David Dodd, who was his assistant, I Columbia. Yeah. Yeah, Columbia. And the thing is massive, it's like 800 pages. But it's basically the foundation of to your point, Dave, when we invest, we try to figure out what a business is worth. And it's really worth all the future cash it generates by but to actually quantify what that means in the world that's so complex, and always moving is a really hard thing to do. But security analysis can help you start to understand some of those concepts. And what stuff is like it's so much more than just numbers, right?

It's not just oh, Coca Cola made 10 million in profit last year. So it's worth this. It's like, well, Coca Cola has to compete against Pepsi, but they also have to compete against the next innovator like stevia, for example, you know, that there's just so many parts of investing in the stock that can somewhat be overwhelming. But security analysis is like a literal textbook. And if you drop it on your desk, it's gonna make everything on your desk vibrate, right? It is like a little textbook, but it's been so educational for so many people, but it does feel very advanced, because it is worthy. And was written a long time ago. Yeah. And there's a lot in there. But yeah, I would recommend at least giving it a try.

Dave

19:20

Yeah, me too. And if nothing else that serves as a weapon too. So

Andrew

19:24

because it's so heavy.

Dave

19:29

But yeah, I agree. It's probably one of the deepest books there is that I've read about finance. And it's, you know, there's no sugarcoating it. It's, you know, there's a lot of advanced topics in there. And it definitely you

need to work through it. It's not something you're going to sit down and read on a Sunday afternoon, and, you know, just kind of for a light reading. It's something you got to sit down and work through. Yeah, for sure. I guess my last book is kind of on the evaluation train, if you will, and that's called expectations investing.

And this is a book written by Michael Mollison, and I think one of the better books on valuation that I've read, and he really talks about the way that you can use a discounted cash flow model, but in reverse, using the one thing that we all know for sure is a hard, fast number. And that's the actual price that the company is selling for in the market. And then working backwards from that to determine what's embedded in that price. Like, what are investors? What is the company?

What are analysts? What are all the people expecting the company to grow the cash flows at this level, or the revenues at this level, or what are their inputs are really driving the price in the stock market. And it's a complex topic, but the way he describes it, he has several different levels of things that he walks you through. And once you understand it, it's all like the but when you just think about sitting down to think about it from without understanding what it is he's working through, it seems a little daunting. But once you read through the book, it's very laid out very well and quite easy to read. And it's very logical as well. And I've been a big fan of I've read it three or four times now that it's good.

Andrew

21:02

I like it. I like the thinking of valuation as a range of outcomes. So I think that's one of the things as you get more advanced, once you actually learn how to value a company, it can be hard, because you think that your estimate is what the future is. But actually, the company could do a lot better or a lot worse than everybody thinks because of, you know, pick outside event that happens that affects businesses. And so he talks about instead of just doing one, think of a range. And I think that's so brilliant.

Dave

21:34

Yeah, I totally agree. All right. That's our list of books that can help get you started from beginner to more advanced. And it's an endless subject. And there's that's just scratching the surface of things that if you want more, come back and ask us and we'll get you some more, go once you get through all those and send us a book report. All right, so let's move on to the next question. So we have hello from the way too hot right now, Eastern Europe. I'm a big fan of your podcast and hope to have the privilege to keep on listening to you guys for many new episodes.

My dilemma is as follows. I have recently earned a big sum of money, big at least for me, it's a six figure number sum, I plan to invest it in the stock market, but I'm not sure how to go about it. I know timing, the market beats timing the market. So going all in might seem the best way out. On the other hand, dollar cost averaging has the advantage of avoiding a very bad moment to buy in bulk and almost seems better for my emotional well being I could spread the purchase out over a number of years and months. But I would have to find a mechanism for keeping the yet uninvested money safe from inflation. What's your take on this? Thank you and keep up the great work, George. So Andrew, you want to go ahead and take George's great question here.

Andrew

22:38

This is a controversial thing. And that's one of those weird things that money nerds will fight about for whatever reason. But it's gonna have a big impact on your results, especially if you're talking about six figures. So think it's worth discussing, I would say something that maybe is not even talked about when this discussion starts is how are you investing it? Are you talking about just throwing it in an index fund, like the s&p 500? Or are you talking about picking individual stocks?

Because to me, that answer is different. Also, how long are you investing it? Are you investing it for 10 years? Are you investing it for 30 years? Because that also makes an impact as well, I know all the academic studies are I don't know if you call them academic, but a lot of the studies that look back at history will talk about timing, the market does be timing the market in the context of investing a lump sum versus spreading it out over time. So really depends on what your timeframe is and what you're investing in. So there's a lot of different possibilities.

Dave

23:40

I guess, let's talk about the lump sum idea. Like Andrew said, there's studies that show pros and cons for each side of the equation. If you're going to do lump sum investing, here's why I guess I would struggle with doing that is number one,

Andrew

23:56

lump sum investing, index funds or individual stocks? Oh, well, I

Dave

24:01

guess if I was going to do index funds, I would probably be more way more comfortable to just throw all of it in an index fund. I mean, I that's how I would approach it. If I was doing index funds. If I'm doing individual stocks, that, to me is a whole different can of worms. I just think it would be much harder to do.

And the reason why I feel like the stock market in a lump sum like an s&p 500 lump sum would be easier because the market will go we'll see a lot of volatility. But if you span out over a longer period of time, 10 to 30 years, for example, you'll see the market go up over that longer period of time.

So even if you invest in an air quote, bad time, and maybe the stock market is really down, that's actually a good thing because then it's going to rebound and you'll get better returns if the stock market is running really hot, and it's like it was a few years ago for example, then you may lose some in the shorter term but it will will return and do better over a longer period of time. So I guess I would be more comfortable with that. If we start talking about doing individual stocks, then I think that's kind of a whole different can of worms, I guess what are your thoughts on the lump sum? In an s&p 500? Kind of thing?

Andrew

25:15

Yeah, depends on how long we're talking. If you're 55, and you're retiring at 65, you only have 10 years, then putting a lump sum into the s&p in 1999, would have been a terrible idea. Because in 2009, you're trying to retire and your portfolio's way, way down. Well think about the two things you encountered in there. So you got the.com Bust. And you also had the great financial crisis in both of those periods. So that would be really tragic. Yes. But the overwhelming majority of 20 year periods, your returns are fine. So might as well let it ride, if you're talking about 20 years or more, right.

But I understand the emotional uncertainty and how that can be hard. Because over a 12 month period, you can have such a fluctuation in the stock market, and it does feel better to spread it out over let's say, 12 months. That way, you don't have one position that you're staring at in your brokerage account. That's either up a lot or down and a lot emotionally, yeah, it does feel better, but 20 years away, 30 years away. And if most of your retirements going to be in an s&p and UA, you're kind of ride or die with the s&p As It Is. So I understand like, the historical studies that say time in the markets better than timing the market. But the longer your time period, I think the easier that becomes so what about individual stocks,

Dave

26:43

see individual stocks for me, I would have to space it out, I just couldn't, first of all, I wouldn't feel comfortable. I'm not Warren Buffett, I wouldn't feel comfortable putting half of my money in one stock, I could not sleep at night doing that I wouldn't be able to. So for me, I would have to space it out. Now, whether I do it over, you know, a year, or whether I do it over two years, or however long and simply for the fact that that trying to find 10 Great ideas or 20 Great ideas, all in one shot, I think would be really, really, really hard. I know that I couldn't do it. Could I find 20 companies that maybe I want to invest in? Sure, absolutely. I got listed those right now.

But what I want to invest in those right now? Probably not. And so I guess for me, I would have to space it out figuring out whether I want to have 10% positions or 5% positions, all those things would kind of play into that decision of how long I want to to spread it out. And maybe throwing in a hypothetical to let's say that the market is going through a downturn, why I'm investing this, then I may actually accelerate some of that, because that's when I could find companies that are selling for a discount, you know, Google, Microsoft, or all of a sudden on sale? Why not take advantage of that way you can or visa, you know, something like that. But if I'm going to look at it, just as a general rule over a longer period of time, I'd want to spread it out. What about you?

Andrew

28:08

Yes, I think the Buffett idea is really interesting. Because even I think he would say when he put half of his money, or almost half of his money in that company, he didn't just do it. Because he had a bunch of money necessarily. He did it because he saw this as a crazy opportunity. And I'm gonna swing really hard at it, right. And he's proven that that's worked out really well for him. And he doesn't do whatever he wants. He doesn't do it every year. It's very rare that he loads up like that, right. And it's just because like, the prices are pretty fair. There's not huge discounts all the time. Every once a while when one does happen. You gotta take a big swing. And that's what Buffett did.

Dave

28:51

Right? Yeah, exactly. And more power to him. That's just not in my DNA.

Andrew

28:56

I'm not putting 40% something. Sorry. Yeah. No, no. All right, we're gonna wrap up with our last one, this one's going to be really advanced. And it'll be fun for me and Dave, for the rest of you will see. Hello, Dave and Andrew. Thank you guys for all the great content on the show and love the website. I'm interested to hear if you guys include operating leases in your wack slash cost of debt calculations, and your logic for or against.

When I started listening to the podcast about two years ago, I wouldn't have had any idea what that sentence meant as I had no finance or business background at all. I appreciate all your guys wisdom and enthusiasm that helped me get to this point. Seth from LA.

Dave

29:38

Yeah, it's a great question. And again, this is a little more advanced, it's a lot more advanced. So if this is something you're not familiar with, please feel free to check out our website at investing for beginners.com and do some research and come back to this you'll understand it a little bit better. Alright, so I guess we'll start with what is wack or cost of debt. So I think the first thing we need to kind of describe whack is an acronym for a weighted average cost of capital. And cost of debt is part of that calculation. And long story short, a whack or weighted average cost of capital is you're calculating a discount rate that you use to value a company, you can think of it as a hurdle rate, you can think of it as discount rate, there's a lots of different ways. Basically, what it is, is,

Andrew

30:29

and we talk about the hurdle rate, because I think if you're someone who hasn't been around a while, you might not know what's referring to. And to me, the whack for most companies, at least the ones I look at the mature companies, they're not actually raising capital. So if you're really a hurdle rate for the investor, in that it's more of an opportunity cost of capital than it is a cost of capital, right. So maybe talk about the hurdle rate and why that's such a big part of the discount rate.

Dave

31:01

Okay, so the hurdle rate is to break it down as simply as I can, is the return that you would want to get on your investment. So if you have actually a whack, and it comes at back at nine and a half percent, if you invest in Microsoft, you want two weeks to get a nine and a half percent return for you to feel like you've invested your money well. So anything a nine and a half or above return on an investment in Microsoft, you would consider a successful investment, anything below that, you would feel like you've burned your money. And so a whack or hurdle rate or discount rate, those are a discount rate and a hurdle rate are really the numbers that you use to discount the cash flows that the company generates.

So the reason why you do this is because of the time value of money. So $1, today is not worth the same as it is tomorrow or two years from now, or 10 years from now. And so we have to use a discount rate, or a hurdle rate, or the whack to determine what that value is for that dollar 10 years from now. And basically, because of the buying power of the dollar or inflation, your money isn't as worth as much in 10 years as it is today. And so we want to make sure that when we invest that dollar, that we get a nine and a half percent return from now until that 10 years otherwise, we could have chosen other companies to get a better return on that dollar.

And Andrew was talking about opportunity cost, that's really what that comes down to is the when you invest you have the opportunity, you have choices to make, you can buy this, you can buy that you can buy this, you can buy that, and the better return you get is a better use of your money. And so if you invest in a company that doesn't perform well, and you don't get a great return, in 10 years, as you do the other one, for example, then that's an opportunity cost you lost. And that's 10 years that you can't get back to invest in another company. And that's why these calculations are important, and why it's something you need to think about and kind of to work through. And so does that help explain it?

Andrew

33:11

It does, the only thing I would add is it's all risk adjusted. So the more risky a stock is, the higher the discount rate. And the reason for that is, let's say you have 10 stocks, so they're all too risky investments, and nine of them go bankrupt, your last one stock needs to have a huge return for you to break even, right, versus if I'm buying Microsoft, Apple, Google, like a lot more safer companies, those discount rates can be a lot less, because I don't need Apple to 10x from here for me to have a good return, because I'm buying steady growers. So the reason why the hurdle rate needs to be higher for more risky companies is because it's risk adjusted, you know, it's a more risky company. So you attach a higher discount rate.

Because those companies are going to need to earn more than normal because your portfolio is going to have if it's more risky, there's more chance that it will go bankrupt. So keep buying companies like that you have to have companies that return a higher rate. And then you can like you can that's one extreme and then you can take that all the way down to investing in bonds, or investing in something even safer than that. And then the discount rates go down. Right, exactly.

Dave

34:28

Exactly. So that's a very good, very good point. But one of the things about the whack is it is a way for investors to determine how well a company invests because this is their cost of capital. And it's the capital that they use to invest is broken into two parts. Part of it is debt, and part of it is equity. And those are the two choices that management has to choose to try to generate investments that the company can do better than that. So if Microsoft to go back to them, if they're going to participate in a project or a plan to try to grow revenue, they have to do better that investment that they spend, they need to do better than that wack or that cost of capital for it to be worthwhile for Microsoft, which in turn would be good for the investor.

And if they don't do that, then that's a poor choice of using that capital, they could have given us a dividend. They could have done share buybacks, or chosen another project, or maybe an acquisition. So when you look at how management allocates the money that they generate from revenue, whack is one way that you can help measure how well the company does that. And like Andrew was saying, the more mature companies generally have a lower whack or lower cost of capital, it's not always that way. But generally, they will have lower cost of capital, and it means that they're going to invest more efficiently.

And without going into all the nitty gritty, you can compare return on invested capital to whack and the higher the ROIC is, in theory, the better the company invests, because that's the return they get on those investments. And that's why those two components are so important to look at. And that's why I spend a lot of time calculating whack and looking at it, because it's important. And the other part of this too, and this doesn't get discussed a lot is interest rates have a big impact on the cost of capital or the whack because debt is generally is a cheaper way of investing versus equity of a business.

So when I'm talking about equity, I'm talking about Microsoft selling shares out in the open market. And that is more expensive for Microsoft to do than it is for them to go and borrow money to try to raise cash to use an investment. And so the interest rates, when those are really, really low, like they were a few years ago, that meant that across the board wax or discount rates were lower, in general, which means that companies

could invest cheaper, and they could take on more debt and have less to pay. It made them more valuable, if you will, it basically drove up equity prices.

So when you saw the prices of a lot of these companies that were very, very high and very elevated, it's because the interest rates were so low, and the cost of borrowing was so low. And so there's a relationship to it. And that's why I like to use something like a whack because it takes that into consideration. There are some people out there that when they invest, they use just a flat 10%. That's my discount rate, that's my hurdle rate doesn't matter where we are in the interest cycle, and everything. And that's fine. And if it works for them more power to them, but I like to use the whack, because it takes him

Andrew

37:58

fine, though. Well, it's not they're wrong.

Dave

38:01

So I think they're wrong. So and here's why I think they're wrong, it doesn't take into consideration the impact that accompany decisions a company will make, to borrow more money to invest. And you know, we're talking about Microsoft, and maybe Microsoft's not necessarily the greatest example, because they generate so much free cash flow that they don't really have to take on a lot of debt, they can do it. And they do do it. But they do it so cheaply, because they're one of the only companies that's a triple A rated company, so they can borrow at the lowest of low.

And you know, they have such great financial strength, that it's not apples to apples with PayPal, for example. And so if you look at PayPal, interest rates have a real big bearing on PayPal and their ability to reinvest in their business, because if they don't generate enough cash flow, they're gonna have to rely on debt. And if they don't have as good of credit rating, as Microsoft does, that means that they're going to have to borrow at higher rates, which means that that's going to cost them more money.

And that means they have to invest that money better, then Microsoft will not necessarily like range of return on capital, but it does mean that they're gonna have to, there's a lot more pressure to invest well, then Microsoft can miss on a few things and not be as catastrophic as it could be for PayPal, for example. And that's why interest rates are important. And that's why I like to look at something like a whack to help me

determine what kind of discount rate I want to use for my cash flows. Because that cost of debt that Seth asked about, that's critically important to a CEOs decisions.

You know, when he sits down at the end of the year, he's got so much money to play with. And he's going okay, we got these plants. We want to do this. We want to do this and we think this is going to be the thing that's going to help pay pal grow. You got to pay for it. It's not coming it's not going to be free. And so if you don't have the free cash flow You have to raise the money in other way. And the two choices are debt or equity and equity is, you know, a lot of people frown on myself included, because it dilutes shareholders.

And so interest rates have a direct impact on decisions that CEOs make on how they're going to capitalize their investments. Because every company, including Apple, which is probably one of the greatest in the world, right now, still has to invest. And the CEO, Tim Cook has a decision to make every year how do I want to do this, and because their financials are so awesome, and they got, you know, gobs and gobs of cash flow, he has different decisions to make, then the you know, the CEO that's running Pay Pal, for example. And so I'm not trying to pick on Pay Pal, but their financial realities are different,

Andrew

40:45

they are kind of going back to the hurdle rate, you know, at the risk of being like overly simplistic Tim Cook, or Satya Nadella or any of the CEOs who are reinvesting the cash flows that come from the business, if they can't beat the hurdle rate on any new projects, then they should be giving that back to shareholders. And that's where the hurdle rate or the whack not only becomes useful in valuation, but to your point, when the CEO is looking at how do I want to allocate the capital. And so that's why it's used a very good way to see if companies are managing, actually creating wealth for the shareholders through the reinvestments. Right. So I guess, to answer the question, do you include operating leases in the cost of that?

Dave

41:30

I do. I do. The accounting gurus, the leaders of the accounting world decreed a few years ago that operating leases needed to be included on the balance sheet as debt for the companies. And when I calculate the total debt of a company, I include operating leases, some companies, operating leases are going to be a far bigger part of their debt than others, I'm looking at a company called Fastenal right now. And they have very large operating leases, because of the nature of their business. And so they have a lot more debt and not a lot more debt. But if you look at the components of their debt, operating leases is a far bigger part of it, then Microsoft, for example.

Andrew

42:10

I also full disclosure, I don't calculate whack. And that's because I calculate the cost of equity instead. And that's because I'm looking at free cash flow, the equity instead of valuing the entire firm, however, when you talk about do I want to put operating lease in as debt or not, I also subscribe to that idea that you should. And also when you do it for invested capital. And this is something we've debated maybe too hard for a while the mental model that helped me understand why this is the case.

Because really, when companies going to, I like to think of real estate as a good example, like, if we're going to buy land to put our retail store on, or we're going to buy it or we're going to lease it, you buy it, then it's capex, right. And then it goes on your balance sheet under long term assets. If you lease it, it's not capex, but it's a finance lease. And then, but now, it also goes on your balance sheet. But if you think about the way companies actually do capex, I don't like I'm not CFO. And I'll know exactly how this works as far as the in the trenches, nuts and bolts, but a lot of the capex is spread out over many years, and you make payments on it in that way. And so whether you buy or you lease, you're still making payments.

And so, you know, you might argue, well, an operating lease is a way to free up capital, because you're not owning it. And that was the way I thought about it for a while. But if you take that argument a little bit further, you're still basically locking up future cash flow that needs to be paid. And so it should be considered just like you're either paying the bank, or you're paying the landlord, the landlord. Exactly. Thank you. And so to me, that's, then it should be included, it should be thought of as that

Dave

44:04

that's very well put, the best way to think about it is it needs to be included in the debt calculations when you're considering the cost of debt for a weighted average cost of capital because it does impact again, it impacts the CEOs decisions and what he wants to do when he allocates capital,

Andrew

44:19

you know, if I can go get 8% return at a much lower risk than, you know, Microsoft investing and generating 7% than they should have given that to me as a dividend. Right. But luckily, they haven't done anything like that in a while. So no,

Dave

44:35

no, no, they haven't. But I think the bottom line is, that's all part of analyzing management. Yeah, and how they allocate the capital. And that is job number one, Michael Mobizen. has said this repeatedly throughout his writings that and Warren Buffett says the same thing that allocating capital is the number one job that all CEOs have. And the ones that really do it well, are the companies that you really, really want to buy because that is The most important thing that they can do, and if they're not just a figurehead, and if they don't do that, well, then that will impact the financial performance of the business in some way, shape or form.

Sometimes it can take a while because the company could be just that great that, you know, a Dum Dum can run it for a while. And it takes a while for those decisions to impact the returns of the business. But eventually, it will. And that's why it's so important to really understand this concept and as well as what management is doing with the money they generate. All right, everyone. 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.

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