IFB319: Cutting Losses -A Guide to Exiting Bad Investments

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Dave [00:00:00]:

All right folks, welcome to Investing for Beginners podcast. Today we have episode 319. Today we're going to answer three great listener questions we got and this is going to be fun. So here we go. We have. Hello, Andrew and Dave. I have two questions. Number one, I have been dabbling in the stock market for a while.

Dave [00:00:17]:

I have made some great investments like buying Microsoft in 1997 and some bad ones like selling Amazon in 1998. During the pandemic I got caught up with a frenzy of reddit and made some very bad investments. When do I fold? Should I bite the bullet and sell or hold on hoping prices will go up? Some of these investments went from one hundred and twenty dollars to fifty eight cents per share. And then the second part of the question, which we'll get to here in just a second is what is the best app to keep track of your investments other than the broker that the one is using? I love Robin Hood but deleted it because of bad investments. Thank you Adeline. So this is a great question and yeah, you've been doing this for a little while so congrats on the buying Microsoft in 97. That's awesome. So I guess Andrew, what are your thoughts on the first part of the question? It's kind of cool.

Andrew [00:01:03]:

It is kind of cool. And yeah, congrats on the Microsoft. I feel like I want to shake your hand or something. That's a great thing to be proud of, right? So focus on that. Don't focus on all the red in your portfolio. In all seriousness though, yeah, that's tough. I mean it sounds like you already think that these are bad investments. So if you already know they're bad investments, I don't understand what the logic is to keeping on to them.

Andrew [00:01:27]:

Other than there's a very emotional bias of when you take a loss in the stock market. You just want to hang on until it rebounds and you can make your money back. Because that feels so much better than having to sell a stock at a loss. That's a really potentially fatal way to invest your money because you're taking more of a gambler's mentality instead of an owner's mentality. When you buy stocks you're buying part pieces of a business and so that's a different way of approaching how a stock price moves and when you buy and sell than just solely wanting to hang on to a stock because you're waiting for it to get back to even. What do you think? This is a kind of hairy situation.

Dave [00:02:12]:

It really is. I think there are several things I guess I think about when you see these kinds of stories and how would I react to them. I guess the first part is the market will punish companies that are doing poorly and over time we have to remember that in the short term the market is going to be more of a weighing machine. And in the long term, it's going to be more of a voting machine. So basically, in the short term, you're going to see wild fluctuations in price, in movement, in emotions, thoughts on the company narratives, all those kinds of things. But in the long run, the financial performance of the business should take over and dictate how well the company is doing. And so without knowing the ticker of this company, it's hard to assess whether the company has been hammered that much because it's not performing or because the tide has gone out in the sector that they are in and it's taken off boats with them. And maybe this company in particular has been beaten down really hard.

Dave [00:03:13]:

And so it's hard to know exactly what is prompting the drop. And so the reaction to the drop and why it's done that can vary. And you have to remember that the fundamentals in the long run are going to drive the performance of the business. And so I'm going to give you an example of something that's kind of happened to me recently. Ajin, which is a company that I own. It's a Dutch payments company. I've owned her for a couple of two, three years now. Just recently, about three months ago, the company got hammered.

Dave [00:03:45]:

I mean, hammered, lost 50% in two days because they didn't meet the expectations that the market had for the growth as well as the revenue targets and some of the profitability. And without going into all the nitty gritty of all that, if you look deeper into the actual financials of the business and listen to what management was telling you, you had a choice of believing them or not believing them. And if you did believe them, then everything that was happening was perfectly logical and made a lot of sense. If you didn't believe them, then obviously the company is not hitting its marks and you need to get rid of it. Three months later, they uncharacteristically had another earnings call. They're in Europe. And so their timing of earnings calls is generally every six months. So they decided to do every three months this time because there's been so much market negative sentiment around the company.

Dave [00:04:40]:

And they did an earnings call, they did basically an investor presentation. They sat down with a lot of the management of the company and spent a couple of hours talking to analysts and everybody about everything that was going on with the company. Two days later, the company is up like 40%. And so just huge rebound. It's not quite back to where it was because of kind of the law of compounding and how the math works, but the company is back on everybody's good graces and it's returning. But the point of that whole story is that in a short term, you can see that the fundamentals were still clicking along like they should have been, but the market sentiment turned. And so the tide went out and the company dropped. And when the narrative changed, then the company came back in.

Dave [00:05:27]:

But the fundamentals are still performing the way they should be. So in five years, hopefully, the company will be much more valuable than it is today. And that's part of the joy of investing. But the whole reason I told you I wanted to kind of relay that story is sometimes the market will punish a company because the narrative changes, the tide goes out on the sector, but sometimes a lot of times it'll get it right and it'll punish a company that's not performing financially. And so if this company it kind of seems like you don't think it's doing that great, then maybe it's time to cut bait. Because if you don't feel like it's performing well financially, the market's not going to just reward it just cut. It's got to prove that it can be a profitable, valuable business. And if it's not doing that, as painful as it is, it's better to cut bait and take the loss, move on and find a better opportunity because otherwise you're just going to drive yourself crazy.

Andrew [00:06:23]:

That's a super good point and a really great distinction that you do have two very different reactions to what could look like a similar drop in price. And you look at a company like Bed, Bath and beyond is one that went bankrupt recently. I mean, the price went down and then it went down and then it went down. Then it went down. Just continue dropping. And that's the way stock prices work. They'll continue dropping 50% 50% 50%.

Dave [00:06:50]:

Right.

Andrew [00:06:51]:

And when you have a business that's struggling to stay survive, it's shrinking, all of those things.

Dave [00:06:56]:

Yeah.

Andrew [00:06:56]:

There's a reason why that's going to continue to go until it probably drops all the way to zero. So that's a very different situation than what Dave was talking about. And that's where it pays to know, is the business good or is it it's is it a bad business or is it a bad investment? I think that might be a good way to ask yourself, right?

Dave [00:07:16]:

Yeah, very true. So I guess moving on to the second part, what do you think is the best app to try to track your investments?

Andrew [00:07:22]:

I like seeking Alpha. What about you?

Dave [00:07:25]:

Yeah, I like seeking Alpha. And I also like fidelity as well.

Andrew [00:07:28]:

I use both.

Dave [00:07:28]:

I don't have Fidelity on my phone, I just have it on my computer. So we've talked about that before. It acts as a speed bump, so I can't just react and see that Odgen is down 50% and go out and sell all of it because I want to jump off a bridge. I find Seeking Alpha is very user friendly and it allows me to track the investments. And it works really well on the app on the phone as well.

Andrew [00:07:51]:

Yeah, perfect.

Dave [00:07:53]:

All right, let's move on to the next question. So we got. Hey, guys. I've been listening to the podcast for a couple of months, came in kind of late to this. I am currently trying to catch up on past episodes, and I may have missed it, but have you guys ever talked about what happens to your holdings when a spin off occurs? I currently hold three M, and I'm reading that they will be spitting a division soon. What does that mean in stockholding terms, and will it change the shares?

Andrew [00:08:18]:

I have?

Dave [00:08:19]:

So, Andrew, what are your thoughts on this question? It's a really good question.

Andrew [00:08:22]:

It is a good question, and we may or may not have covered it, but I'm happy to answer it anyway, because this happens all the time with stocks. We recently had this happen over at Value Spotlight. A company we own called Danaher did a spin off. And so what they did, they spun off these shares, Vlto, and basically what happened, for every three shares of Danaher that you owned, you would get one share of Vlto. So every transaction is going to be different. Maybe you hold one share and you get one share of the new spin off. Maybe you hold one share, you get ten shares of the new spin off. Whatever they announce is what's going to happen.

Andrew [00:09:02]:

But basically, when it's a spin off, and if that's all it is, is a straight spin off, then they're taking a division of their business. It's becoming a new business, but it's not just becoming a new business. And you, as a shareholder, part owner of the business, get screwed over. You also get your equivalent share in the new business as well as hang on to the share in the old business. And so that's kind of how it works.

Dave [00:09:26]:

Just to clarify, you don't lose so if you have three shares of three M, for example, and they spin off one, you still own your three shares. You don't lose those shares, correct?

Andrew [00:09:36]:

Yes.

Dave [00:09:37]:

Okay, so what would be the upside to owning a new business? Or what would be the downside to owning a new business from these spinoffs?

Andrew [00:09:47]:

I don't know. I don't want to say it out loud because I don't want to make it happen for my portfolio holdings. I don't want to put it out in the atmosphere and make it happen. But let's say I don't know. What was the big spin off recently?

Dave [00:09:59]:

Johnson and Johnson. Yeah.

Andrew [00:10:00]:

Johnson Johnson is a good example. So I think they spun off their consumer products division, and they also kept on their usual biotech not biotech, but biopharma division.

Dave [00:10:14]:

Right.

Andrew [00:10:15]:

So let's pretend that Johnson Johnson's Consumer Products, they had the cure the cancer in a little box that you could buy at Walmart. If that was truly the case, then that stock would take off. Right. And maybe they would have never come up with that product if it wasn't its own business that could focus just on consumer products. So I guess some of the benefits to the businesses and so sometimes it can unlock some magic inside a business as they refocus on other things. And then you can get a big upside from a new business or the old business that's now refocused.

Dave [00:10:55]:

Yeah, the whole spin off thing can be very interesting because sometimes they can unlock a great business that can be sometimes it can be a better investment than the old investment because maybe that is the best performing or once it's unlocked from the parent company, it's allowed to spread its wings and becomes a much better business than maybe it was being managed by the current management. So sometimes it can be a great investment and sometimes, unfortunately, they can also spin out all the trash. There have been companies that have done that as well. There was an insurance company I'm blanking on the name of it now, but a few years ago there was an insurance company that I followed that they kind of did that. They spun off a division and they put all their bad debt and all their liabilities and lots of junk in it and then spun it off. And then the invest I mean, it pissed off the shareholders because they didn't want it. They didn't want it in the company. Now, why do I want to own it separately? So I wasn't intimately involved in the company.

Dave [00:11:52]:

So I just remember that people were upset about it and it did not go over well. I think the other business is probably out of business already, probably already gone bankrupt, which is probably the ultimate idea anyway. But there are certainly upsides and there can be some downsides, too. So it really just depends on the company. There are people that do this for a way of investing. We had Rich Howe on the show a while back and he is fantastic. He's super smart guy and this is the way he invests. He follows companies and looks for spinoffs or unlocking of different divisions of different companies so that they can take that public and it could be valuable.

Dave [00:12:31]:

And so if you're really interested in that kind of thing or you think that that's interesting, check out Rich Howie. He has a YouTube channel, and I believe he's on Twitter as well.

Andrew [00:12:42]:

Stole the words out of my mouth.

Dave [00:12:45]:

Sorry. All right, so let's move on to the next questions. Hopefully we answered that question for you. So we got Dear Dave, Andrew, thank you so much for a tremendous podcast. At least it is for me, a fulfillment of all of what you promised to be, having lost about 70% on ChargePoint. CHPP I have two questions. Number one, you have mentioned before that even Warren Buffett lost more than 50% on some investments and keep it. Do you have a rule when to quit? So why don't we go ahead and answer that first part and then we can tackle the second part.

Dave [00:13:16]:

Yeah.

Andrew [00:13:16]:

Shout out to Gilbert. And you, Dave, you guys have come up with the easiest thing to remember. Just ask yourself, has anything in the business fundamentally changed? And that's the rule.

Dave [00:13:28]:

Yeah, answer that. Yeah, exactly. If you can figure out has anything fundamentally changed in the business? If it has, then it's probably time to go. If it hasn't, then it's probably time to try to keep it. Some of it will depend on how much of it is in your portfolio. Some of it is, how well do you know the business? How well do you know ChargePoint? I admit I don't know it that well, and so I would probably be in the camp of but sounds like from the rest of the question that this is something that's in your wheelhouse and you're interested in. So yeah, I think that's probably the best way to look at it. If nothing's changed, if they're not going from charging cars to selling spaghetti, then you probably should hang on to it.

Andrew [00:14:11]:

Would there be good ways to identify that that something has changed?

Dave [00:14:16]:

You'll probably start to see it in things like the financials. You'll start to see changes in the margins, gross margins, operating margins, net income. Start seeing it in some of the metrics like return on invested capital, return on equity, things like that. You'll start to see payoffs or gradual declines. If you start to see those kinds of things, that means that something is going on that it's not something you want to look at just on a one year basis or a couple of quarters. You have to look at it for a longer period of time. And if you see a gradual decline in revenues, for example, or you see a gradual decline in profitability, like the net income is gradually decreasing or the gross income is gradually declining, those are yellow flags that, hey, something's going on here, and then it's up to you to figure out what it is. But again, you have to look at it for a longer period of time.

Dave [00:15:10]:

ChargePoint is, I think, a younger company, so it may be a little harder to look at something like that on a shorter time frame, but those are definitely things you'd want to look at. Anything I missed or anything else you'd add to that.

Andrew [00:15:24]:

Curious how you would rank those, if at all, or does it really depend, like importance between market share, growth, margins, return on invested capital, efficiency, balance sheet.

Dave [00:15:38]:

Whatever, right, yeah, that's a great question. I think the first thing I guess, number one for me would be, which is an easy thing to do, would be to look at the ROIC of the company and see how that's trending. Because the better the company can invest and the more efficiently they can do that compared to the cost of doing that without getting into all the numbers of it. That kind of idea can go a long ways towards whether a company is going to continue to perform well because the better it can reinvest. And every company has to reinvest, even the best ones, like Apple and Amazon. The better they can do that, the more likelihood is that they're going to continue to be successful over a longer period of time. And maybe what you're seeing is some sort of cyclicality in the industry, or maybe what you're seeing is there's a big new competitor that's come on the scene, and there's a battle going on on seeing who's going to be the top dog kind of thing. So those kinds of things can happen as well.

Dave [00:16:40]:

But I think for me, ROIC would probably be the first thing I would look at, and then the next thing I would probably want to look at would be revenue growth and along with profitability on the income statement. And then you can go farther down the list. How about you?

Andrew [00:16:53]:

I've had some pretty painful mistakes along with revenue growth, so I think that's where I tend to go first. But to me, I don't think just because something catches my eye doesn't mean that that's going to be my basis for wanting to sell. So maybe I cop out here, but I don't know if I pick a single one.

Dave [00:17:11]:

It's hard to say, look at this thing, and that will tell you everything you know. Right? It's got to be a snapshot. Right. You got to look at everything kind of in conjunction, because one thing does feed into the other, and they can have impacts. If the free cash flow drops off a cliff, that can impact the ROIC and that can impact the revenue growth. And so there's a lot of moving parts to it. So there isn't one metric, unfortunately, that you can just go to and say, hey, this is going to tell you what's going on. It's more of an overall picture, but generally I would look at ROIC first and then look at the other things to kind of get a sense of it.

Dave [00:17:51]:

If revenue growth is great, but the ROIC is lagging a little bit, you may cut them some slack. But likewise, if the ROIC is great and the revenue growth is dragging, you might cut them a little slack. So I can stop rambling. I would say looking at the overall picture and focusing on a list of things, having a checklist, I think is the best way to do that. Including those things in that checklist ROIC, revenue growth, margins, balance sheet metrics all those things should be part of your checklist when you're trying to determine whether this company is changing or not.

Andrew [00:18:26]:

Yeah. Totally agree about ROIC. I think it can help you uncover a lot. And doesn't it stand for Rambling? On and on and on Isn't that the acronym?

Dave [00:18:34]:

Probably, yeah. Sorry, everyone. All right, so let's move on to the second part of the question. So I do understand that this company has downgraded because of the growth in interest rates and its announcements of a share sale. Because I believe in investing for the long term in EV companies. What data should I look at to determine if I should sell or hold the stock? Thank you so much for your insight. That may help for decision making, many other decisions. And this is from OFR So thanks OFR for the great question.

Dave [00:19:03]:

And I guess Andrew, I'm going to throw it back to you. What do you think, how should he look at something like the EV industry and make it determine whether ChargePoint is struggling or not?

Andrew [00:19:15]:

First off, I love the way you worded this know, insight that will help my decision making framework. That's the best way to look at it really thinking about the long term and trying to approach this the right way, kind of maybe flip it a little bit and kind of push back on this idea just for a second. I think there are at the risk of oversimplifying, I think you have two categories of stocks. You have stocks that are in the high growth well, I mean it's a whole life cycle. But if I really had to say you have really high growth and then you have more stable cash flowing businesses. So I stick on the stable side. The high growth side is more like where point is now. And the reason why I say that after looking at the company for like five minutes, I see that the revenues are growing like a weed.

Andrew [00:20:06]:

I see that they have negative earnings, which is pretty typical. And the fact that you said that they sold shares also that's a very common indicator that high growth companies will have something that they do a lot. So all that to say, the overall portfolio construction of those type of stocks needs to be different than a mature kind of stable portfolio. We just had Jason Hall on a well for us it was yesterday, but I don't know when in the schedule it's going to show up. But it's a great episode and go check it out. And he talks about how his high growth portfolio has a lot, he has like this barbell portfolio where he has a high growth section, but there's a lot of companies in there and it really makes sense because when you have new industries, it's like a brand new forest if you can imagine what that looks like. There's going to be all these different species that are growing like weeds trying to compete and at the end one or a few are going to reign supreme, but it's hard to know which one that is. And so the more of those you can put in your portfolio, the greater chance you have that you will find the next Tesla or the next Airbnb or somebody like that and pay for a lot of losses in a portfolio.

Andrew [00:21:30]:

And so the way I would look at understanding why my kind of stock fell like a stable, cash flowing stock, what I'm looking at is going to be different than what a lot of high growth investors are going to be looking at. And so that's why I kind of want to present it from the portfolio perspective instead of just the individual stock perspective, I guess. What are your thoughts on this whole investing long term in EV companies and what data to look at?

Dave [00:21:57]:

It's an intriguing question, because you're talking about I like the idea that you kind of split the stock universe into kind of two general camps. And I think that's probably a really good way to look at it. And when you think about the EV market just in general, it's a disruptive industry, and it's disrupting something that's been in place for 80, 90 years, and it's going to be volatile. And so trying to I think when you think about trying to invest in those kinds of industries, you're going to see a lot of volatility. You're going to see a lot of ups and downs. You're going to see a few winners and a lot of losers. And that's kind of the nature of capitalism, is for these people to come up with great ideas like ChargePoint, to come up with a great idea of developing a system to charge electric vehicles. It's obviously the more popular those vehicles get, the more needed that's going to be.

Dave [00:22:58]:

So that infrastructure part of that industry is going to be necessary. And so that's awesome. But are they going to be the winners? Are they better than limited in my knowledge of this? So I'm going to limit it to this company and Tesla, because that's really all. And so, you know, the question I would ask myself if I wanted to invest in ChargePoint, are they that much better than what Tesla offers? And do they have an opportunity to expand beyond what Tesla has already built and is continuing to build? And is Tesla going to be the winner? Can there be more than one winner in the industry? A lot of times there can be multiple winners in an industry, and two or three companies can coexist for a long, long time. Look at Visa and Mastercard. That's a perfect example of a duopoly in the payments industry that have existed together for 50, 60 years. I guess the question I would ask myself is, how can I determine, what is that growth point? How many EV stations do they need to get to be where they're profitable enough that they become a little more stable? When you're really investing in brand new technologies early on, it's super exciting, of course, and you see huge numbers of revenue growth. But trying to determine a winner, I think, is really hard.

Dave [00:24:17]:

It's way beyond my skill set, I'm not going to lie. And so kind of to go back to what Andrew was know, I think Jason Hall's idea, I think is kind of the perfect way to think about something like that is having a basket of these companies, as opposed to putting all your eggs in one basket is trying to have a lot of baskets in this industry. And then the winners are going to rise to the top and the other ones are not. And like Andrew said, those outsized winners in this industry will help make up for the ones that fail, that go out of business, that don't ever become profitable, that kind of thing. But the trick is to make sure that you don't put all your eggs in one basket in something like that. Because you're really then betting on that company really being the next Amazon. And if they don't, then that's a harder place to be. And I think kind of spreading your bets or diversifying, I guess maybe is a better way of thinking of it is probably the way that I would go.

Dave [00:25:12]:

I don't know the industry well enough to give any data that, hey, look at this, look at this, look at this, because unfortunately it falls outside of my purview. But I think the way Andrew kind of framed it I think is a great way to kind of think about building a mental model to invest in companies like this or others in different industries as you go forward in your investing career.

Andrew [00:25:32]:

So I'm a 30 little curveball here. I'm going to hide up behind my mitt.

Dave [00:25:39]:

Are you lefty or righty? Because I can't hit a lefty's curveball. Just forget about it.

Andrew [00:25:43]:

I'll come back tomorrow after I've mastered how to switch my throwing arm.

Dave [00:25:47]:

Okay.

Andrew [00:25:50]:

If you had to pick one industry where you were going to apply this kind of a strategy of spreading your bets into something that you feel like has a lot of potential, you may have investments in it now or you may not. What do you think you would throw some coin into?

Dave [00:26:07]:

Well, the first obvious one that springs to mind, which is not something I own any of, would be something in the AI industry. That would be something I would probably throw some coin at and throw and I would not just pick one, I would pick a whole bunch to try to figure out which one is going because it's so new so early and we still really don't know where that's really going to go. I think the next thing I would throw at, and this is something I haven't invested in yet, but I've certainly been playing around the edges for a while is the internet security section because I feel like there's lots of different ways you can play that and there could be lots of winners in that industry. But I think that's something that I think is interesting to me and I think will be valuable going forward because the more the internet becomes. That much more entwined in what we do, the more important that's going to be. Because unfortunately there are bad people out there that are going to try to do bad stuff and we got to protect against that. So I guess those would be my two. That kind of spring divine.

Dave [00:27:08]:

What about you?

Andrew [00:27:10]:

Help anyone? Ask me, I guess something in crypto, but like real businesses, not like a shiba inu coin, you know what I mean? Like actual businesses that are actually generating revenues and stuff like that. I think there's a ton of potential there, but it's so far outside what I'm used to that I haven't even yeah, yeah.

Dave [00:27:31]:

I mean that would probably know some of the web three things that we were talking about with Brian Evans the other day. I think that would probably be interesting.

Andrew [00:27:39]:

For sure.

Dave [00:27:40]:

I will say this though.

Andrew [00:27:41]:

I bet you there's ten times more fraud in the crypto space than AI and Internet security combined. At least if we're talking about public companies versus crypto companies.

Dave [00:27:52]:

Yeah, for sure. That unfortunately, I think probably goes a little bit hand in hand with the early adopter, the disruptive, early new technology is that the bad people will flock to the easy money first and then when the money gets hard, they'll go find some other place to try to find easy money.

Andrew [00:28:10]:

Right? Yeah, for sure.

Dave [00:28:12]:

I'd be curious to hear what other people yeah, our listeners, I would be know, let us know what you guys think. What would be some interesting industries out there that maybe we aren't thinking of that are disruptive or new on the horizon that you would throw some as Andrew put coin at be kind of an interesting discussion, so just let us know. Send us the replies at newsletter@dot.com and then we'll talk about it on the air. All right, well, with that, we will go ahead and wrap up our conversation for tonight. Thank everyone for sending us those fantastic questions. Please keep them coming. Again, if you have any questions, if you are curious about anything you want to know more stuff, please reach out to us at newsletter@einvestingforbeganners.com. We read all the emails we get and we will answer them on the air.

Dave [00:29:02]:

It's the easiest way for us to do that. And if you want to have a question read to us, send us one so we can help you out. We can help you learn more about this great thing called investing. So with that, I'll go ahead and sign us off. You guys go out there and invest with the margin of safety, emphasis on the safety. Have a great week and we'll talk to you all next week. Bye.