IFB330: Balancing the Art and Science in Valuation

Dave:

All right, folks, welcome to Investing for Beginners podcast. Today we have episode 330. Today is the start of something brand new for Andrew and I. We are actually recording this live in person together for the first time ever. So we've been doing the show for what, six years now, and this is the first time that we've been able to record together face to face. So this should hopefully way have a lot more energy and should be a lot of fun for us. So this is going to be an experience for everyone. So if it sounds a little bit different, it's because we're recording live and we're together.

Dave:

So with that, we'll go ahead and dive in. Today we're going to talk about the art and science of valuation, one of our favorite subjects. We figured we could try to educate you and not bore you for the next half an hour. So with that, maybe let's start with starting with what is intrinsic value? Like when you and I talk about intrinsic value all the time, what is that? What is that?

Andrew:

Yeah, I can promise you I will try to educate the whole entertain part. I can't make any promises. So let's talk about intrinsic value. Basically, the idea is any asset has a price. It has a value. We buy assets, most of us, because we want the price to go up. We're also buying it because we expect it to generate cash flows sometime into the future. For some stocks, that's way into the future.

Andrew:

For other stocks, it's more for the cash flows. What can you give me right now? And so when you talk about intrinsic value, the idea is to try to put a value on what those future cash flows will be. And then as everybody kind of tries to make that determination, that's how we come up with this idea of intrinsic value. So every stock has an intrinsic value. There can be lots of different opinions on what intrinsic value actually is for a stock. And so I think that's what makes the stock market interesting, is that these different opinions on intrinsic value can create opportunities, and that's where stock pickers can come in.

Dave:

Yeah, exactly. And that's a great definition. And I think one of the things, when I think about intrinsic value is an easy way for me to kind of visualize it. It doesn't apply to the cash flows, which is obviously very important. But when you think about the value of something, whether it's your computer, whether it's the car out in our garage, the home we live in, the food that we buy at a grocery store, those all have a value. And we have all decided as a society, that this is a fair value for a bunch of bananas. We can argue whether organic or not organic are better and whether this price is a better price than that price. But it really comes down to the value you assign for something, and we all tend to agree with it.

Dave:

The price of a car. We figure the intrinsic value of that vehicle is 25, 35, 100,000, whatever it may be. That's an easy way for me to always kind of visualize what intrinsic value is. And it all comes back to the idea of we assign a value, and we as a group of people all can somewhat agree that that's a good price for a particular thing. Now, where it gets fun in the stock market is that there's this idea of the efficient market theory where everything is priced to perfection and there's never a dislocation in price. And I think you and I would probably disagree with that, I guess. What are your thoughts on that kind of idea and how prices can kind of move away from what everybody agrees is an appropriate price for something?

Andrew:

Okay, yeah, let's talk about something that'll get us hated. Yeah, I'm down. I think the way I understand the efficient market theory is that things are efficiently priced and everybody kind of has all the information that we need to look at different businesses. And so the group, the collective, knows the value of something. Once new information arises, we can all use that information to change the price of whatever a stock is, and that corresponds to its change in intrinsic value. I do think that it seems like the market's pretty efficient in pricing things. The problem is, when we're all trying to price something, we're trying to do it based on what the future of a business will be. So last I checked, the future is pretty uncertain.

Andrew:

And so, of course there's going to be inefficiencies in determining that future. And obviously, nobody can be a fortune teller, but I think there can be. In my opinion, you can look at different businesses and say, you know what? I think this business will be more resilient in the future than this business. And sometimes that's reflected in prices, but sometimes it's not. Because while the numbers are very much so not debatable, the resilience of a business can be very debatable. So how can you make that efficient? I'm not sure if you can.

Dave:

I don't think you can. And I think that's where I think this idea of intrinsic value and value investing and buying for a different price and what it's worth really kind of comes into play. And because you think about, you and I can sit here and we can maybe agree that Home Depot is a great company, but we may not agree on what a good price for that is. And the market, as efficient as it can be, is also full of individuals. Yes, there's a herd mentality. Yes, there's a know kind of development and how it moves. But there also can be times where the market will act irrationally. And that's where you can get these dislocations of price.

Dave:

And recently, there's a couple examples that I can think of. Number one is Netflix. When Netflix announced, this is a little while now ago, but when they announced that they were not going to meet subscriber growth like they had for time immemorial, the market reacted very aversely to that. And the price dropped 2020, 5% in a day. And for a company that size, that's a lot of market cap to go bye bye. And it quickly rebounded. So you could argue that that wasn't really very efficient, and there was a dislocation in the way people were interpreting that news. To your point that we all have the same amount of news, but a lot of people reacted differently than maybe other people.

Dave:

I unfortunately, didn't buy into Netflix at that time. That would have been nice. But to me, that's always a really good example of a dislocation based on something that happens in the news, that's not really based on what everybody thinks is the appropriate price for a company. And that's where the understanding of value in companies can really kind of come into play. So maybe we can talk a little bit about the science versus the art in value investing. What does that mean to you? If I say those words to you, what does that mean?

Andrew:

When I think of the science, I think of the numbers and the formulas that are commonly used to value stocks, and there's several, but a lot of them kind of all revolve around this idea that in many cases, investors are looking at the earnings or the profitability of a company and assigning a value based on that very broadly. That's kind of how I look at the science of it. The art, I think, can get really interesting, because part of it can go to that resilience. Part of it can be, I think there's a lot of good value investors out there who, to your point about the Netflix thing, they can look at a piece of news and interpret it better than the rest of the crowd can. And that's either they do that because they understand the business better. They understand the industry better, maybe they understand history better, or any other myriad of reasons that they're able to a piece of news better than other people. And so you can have short term trades within that right, and be able to get in and get out with Netflix, when you see the price dislocating from where it should be. You can also take the long approach, which I try to do, and try to find businesses that can stand the test of time.

Andrew:

And maybe it's not because of anything with the business for this year or the next three, five years, but really because the way that the industry is structured, the way the business is structured, lends itself to be very easy to continue on. And I think it's kind of not hard to see that some businesses are a lot easier to run than others. And that's the kind of unfairness of capitalism. And so, to me, that's an art. I don't know if you can necessarily assign a formula to say this is how you identify long lasting businesses. And kind of throughout that spectrum, I think there's ways to look at the art behind valuation. I guess in your case, when you think of art and science, what pops into your head?

Dave:

I kind of split it into two camps, if you will. The science to me, is the idea of using a formula, whether it's a DCF, whether it's excel spreadsheets, whether it's a dividend discount model, you can go on and on and on. Where those are strictly based on. There certainly is some art to it, but you can easily take a DCF model, look at the financials on Finchat IO, for example, and take those numbers, plug it into the spreadsheet, and get a return, get a value. And there is some merit to that, but I think you have to play into the art of it. All. The things that you were talking about, the intuition, the idea of understanding the business, the moat, what they're doing, how they do, being able to interpret the results, I think, is something that maybe goes under the radar a little bit when you're talking about really good investors that are able to take a bit of news and interpret it the correct way, if you will, or the right way. And so I think, to me, the science of it is understanding the formulas, how they work, understanding the inputs of where you gather the inputs, when you're baking a pie, that's like building the crust, and that's gathering the ingredients, cutting everything and preparing everything.

Dave:

But to me, the art of it is assembling everything in a way that makes it taste the way you want it to. Adding enough sugar so it's sweet, but not enough that it's too sweet, and allowing the bitterness and some of the acidity of the apple to come through the sugar and balance everything out. That, to me, is the art of cooking. And it's kind of the same with valuation. You have to think about taking all the knowledge that you have about Netflix and applying that to Chevron. Sometimes that's not easy to do, but some of those business like qualities will permeate throughout whatever it is you're investing in. And you can take some of that experience and knowledge and apply it to a set of news and go, okay, I know this about Netflix. I know this about the people that consume Netflix, how they're reacting, and how they're reacting to whatever Netflix is doing or not doing.

Dave:

And they can take all that information and synthesize, easy for me to say, synthesize it in a way that their thought process is a lot clearer than other people's. And that's one of the things that I think makes people like Warren Buffett so above us mere mortals, is that they can take that information and adapt it in a way and process it in a way that allows them to make clear decisions.

Andrew:

Yeah, I guess 60, 70 years of looking at financials could do that. So kind of like building mental models almost. And then you can start to apply those to other industries.

Dave:

Yeah, absolutely. That's definitely. I mean, it's putting in the reps and understanding what it is you're doing, and then taking those models that you've learned from value in a company like PayPal, and then applying it to a company like, know, they're same industries, roughly, but if you learn something about this, you can apply it to that. I think that's spot on.

Andrew:

I like that example. Visa and PayPal, can you pull out, at the risk of being too sciency, can you pull out a component of PayPal that can be also applied to Visa?

Dave:

Yeah, I think probably the easiest way that I could adapt kind of that mental model is thinking about the revenue growth for both companies. And let's take one segment of the revenue growth, one segment that Visa has really excelled at, has been cross border payments, for example. And that's one of the areas that they've continued to grow and thrive, even kind of before the pandemic, and especially coming out of the pandemic, that has been something that Visa has allowed them to continue to grow and thrive, and it's something that they're kind of doubling down on and to that point, PayPal has been one of the companies early on, and it's kind of been hit or miss for them. They really try to grow their revenues by trying to adopt cross border payments for them for their business. They bought a company with the idea that they could use that to kind of become like the. I'm going to blank on the name of the company that everybody uses to transfer money across countries. I'm going to blank on it now. Not wise, but it's an older school company.

Dave:

It'll come back to me around 02:00 this morning. I'll remember it. But anyway, that's not really the point. But the point is that PayPal understands that cross border payments can be a very profitable business, and it's something that they can do to drive the value of their company by generating more revenues. Because of all the different inputs and all the different things you think about valuing a company, the one that really moves the needle the most is going to be revenue growth, because profitability comes from that. Free cash flow comes from that. Reinvestment comes from that. And you can be the greatest capital allocator in the world.

Dave:

If you're not generating revenue growth, you're going to run out of targets to target. So with PayPal, compared to Visa, they try to really kind of embrace the cross border payment as a segment of their business that they could use to try to grow the revenues and the profitability of the business. And it didn't work out as well as it has for Visa. It's a little bit of a different business, but it's kind of in the same ballpark. So it kind of relates. But to me, that's how you can look at, you look at the science and understand this is what they're trying to do. But then you look at the execution and the art of it. Two different companies, one has been successful, the other one has been kind of middling at best.

Dave:

And so if you kind of look at that, then you can see, okay, I have to take those factors into account when I value visa and PayPal and project going back to your, what can we see in the future? I have to look and see how PayPal is going to do with this in the future if that's going to be their big revenue growth driver for the company five years from now. Whereas Visa is already pronouncing, this is going to be one of the things that's going to grow for us and help us be a better company. And so you have to know those things and be able to factor that into the science of just plugging the numbers into a DCF.

Andrew:

I think it's a very illuminating example. I don't believe the company that PayPal bought was publicly traded, but if we were to pretend like it was, you would definitely have the science of looking at what the profitability was, and then you could kind of project that, add it to PayPal. That gives you the formulas and all the numbers check out. But I think PayPal and Visa are interesting, because when I think of PayPal, I think of Internet kind of payments, and Visa is very much still, you know, you got to be there in person. Broad generalization, obviously, but even if the numbers look the same, there can be a case where an acquisition for PayPal would make more sense for PayPal and not for visa and vice versa, depending on the context of the business models. Right. And so that could be one place where the numbers can depart from real world results because of the context of the business model, understanding where things can be playing out, where the shareholders want to see it, and where maybe not as much.

Dave:

Right.

Andrew:

So we can kind of think about the science versus the art. And then, in another way, you also kind of have intuition or gut when it comes to making decisions with stocks. So how do you see the role of intuition in investing and valuation?

Dave:

I look at it in, I guess, two different ways. Number one, I think it's critically important to have intuition and to understand intuition and try to embrace using intuition. But I also think it's incredibly hard to do all those things with intuition. Part of my brain is wired to be rational, logical, and look for facts to back up my ideas. And intuition kind of goes off of not that. So intuition works off of your gut feeling and how you interpret different things, and it's not something you can necessarily measure. And so, for me, that can make it very difficult to kind of, I guess, get both sides of that idea to kind of commingle and work together. And I think the best investors out there all have a mixture of the science and the intuition, and are able to allow intuition to guide them.

Dave:

When I think, a lot of us, including myself, sometimes ignore it. And that voice in your head that's telling you you need to buy Novo Nord disc, don't be a dumb dumb. And you push that intuition down because you want more facts. And so I think, to me, that's how I kind of think of intuition in investing. What about you?

Andrew:

I mean, the thing that pops in my mind that's very recent is the whole decision to buy Microsoft recently already had a pretty big position. Well, it's not really that big, but sizable position. And then was considering buying more because ever since I bought it, things have even looked even better than I would have thought. But, like you're saying, it's like, I wanted more facts. I wanted bigger margin of safety. And that's where having you there helped a lot, because you did help me think about it more. And I think that you even asked, like, what does your gut say? And I was like, well, my gut's saying to do it. So I think having that intuition can definitely help.

Andrew:

And maybe for some people, it's actually the warning sign where maybe somebody is used to taking a lot of risk, and your intuition will actually say, hey, slow it down. Or you could be like me on the flip opposite side, where I tend to be a lot more risk averse. But if my gut's telling me, like, yeah, you don't have that same safety you want, but you can see all the facts, like, things look really good. Don't be so scared. I think it can definitely help. And that's where I think if you can listen to it enough, not rely on it, maybe too much too. Like, moderation is very key for things, but I feel like it can be very powerful. And I'm very confident about the Microsoft thing.

Andrew:

I think they have a long Runway of potential.

Dave:

I agree. I agree. I think people should understand that you can research a company until you're blue in the face and know everything there is to know about the company, including the name of the owner's dog, for example. But I think there's a law of diminishing returns. There's a certain point where you know or you don't know that you know enough about the company. And that's where I think kind of learning to trust your intuition and understanding. Do I know enough? Yeah, I do know enough. And I think when you reach that point, I think you'll know.

Dave:

And I think it's just a matter of making a decision and pulling the trigger. It's hard. I get it. It's really hard. But I think that's something that listening to your gut, listening to your inner voice, I think, is something all investors need to probably embrace a little more than sometimes we do.

Andrew:

Yes. Can't argue with that. All right, now let's swing back over to the science. What are some metrics and ratios that investors can use and maybe even if they're beginners? And this is like, I don't know how to pick a stock. I don't know what any of these numbers mean maybe we can throw in a couple of beginner metrics and maybe a couple of advanced metrics that people should consider?

Dave:

Well, I think the obvious first one is price to earnings ratio. That is a very easy metric for everyone to use to give them a relative idea of what the value of the company is. And you can calculate earnings per share, or, I'm sorry, the PE ratio by. There's two ways you can do it. One is you can look at the market cap of the company, and what that is is the market cap. For those who aren't familiar with these terms, the market cap is a combination of the current market price of the company multiplied by the shares outstanding that people could buy. And when you multiply those together, that gives you the market cap of the company. And you would divide that by the earnings of the business.

Dave:

And the earnings of the business is the thing you can find on the financial statements. It's on the income statement. And it's the last line of the income statement. It's the net income or earnings of the business. You literally just divide those two and that gives you a ratio. 1520, you hear people in the industry talk about, it's got a PE of twelve. What that really means is the market cap over the earnings. That division equals twelve to one.

Dave:

And so that means that you're paying $12 for one dollars of earnings or $20 for one dollars of earnings, or in Amazon's case, $77 for one dollars of earnings. And so that's really how that relates. And the other way you could do it is you can take the price per share. So if you look on any financial website, you'll see that a company is trading for 42 99. And that's the price that we would buy it for. And then you would divide that by the earnings per share, which is simply that bottom number, the net income divided by the shares outstanding. And you can find both of those on the income statement. Or you can go to Finchette IO or ticker or koifin or wherever you want, Yahoo.

Dave:

Any place, and find all that information as well. So that's a real easy way to try to value a company generally. Generally, the lower the better. But it will depend on industry and it will depend on cycles of the markets and things like that. But generally, the lower the better. The cheaper the better, I guess, is better.

Andrew:

Yeah. Obviously this can change depending on the market environment, so don't take this as an exact science, but are there ranges that kind of say something about a PE of 15 might say something different than a PE of 35, right. What are the kind of ranges and what do they generally communicate?

Dave:

Again, this is generalities. If you're talking about a PE ratio, I guess for me, depending on the industry, if I see something that's a 20 or 25 PE or lower, I will think that it's either fair valued like it's even priced, or it's undervalued. And anything above that can tend to be more in the overvalued range, if you will. Now, each industry is going to be a little different. So when you look at banks, for example, or something like trains, those tend to have very low PE ratios because they're not as popular in the markets. And so it's not unusual to see a bank, I think ally bank is trading like five or six PE right now, really low. And Wells Fargo is ten or twelve. JPMorgan, probably the best of breed, is 15 or 16 PE, something in that range.

Dave:

So those are all pretty cheap. But then if you look at air quote normal companies, you might find some that are into 2025 range expensive stocks. The tech stocks generally will be higher than that simply because the market values them, their earnings more than they do for Wells Fargo, for example, you'll see a PE ratio for Microsoft of 32, for example. And that tells you that the market values that dollar of earnings for Microsoft basically three times better than they do for Wells Fargo. And that's, I guess the easiest way that I try to look at kind of the ranges of value, if you will.

Andrew:

I think that's super helpful. What would be some of the reasons why investors would value a dollar of Microsoft three times more than a dollar of earnings from wells?

Dave:

Because it's a better company.

Andrew:

Duh.

Dave:

It generally comes down to the company feels like it's going to produce more value, I e, more free cash flow over a longer period of time, which makes the company more valuable than the other company. It really comes down to the expectations the market has what they think the company will produce. That will drive value for the shareholders, us. That's really what all those numbers come back to. So that's why you'll see Amazon or Microsoft or other companies. I'm trying to think some popular Internet stocks at the moment, I'm just a blanket on them. Some of those companies will carry very high PE ratios and that's because the market has a higher expectation for them than they do. Ally bank, for example.

Andrew:

Yeah, I mean, I could see Microsoft growing three times faster than wells.

Dave:

Yeah, me too.

Andrew:

Any advanced metrics or ratios?

Dave:

Well, I guess the two that you and I like probably the best are price to free cash flow and return on invested capital, which is not necessarily technically an evaluation ratio, but it certainly plays into value at companies. So you want to tell our friends and family about fans about those two?

Andrew:

Yeah, not much family as nerdy as I am. So the return on invested capital, I've seen research from Michael Mobison suggesting that there is a higher valuation multiple attached to companies with higher return on invested capital, or ROIC. And to get super specific, he's talking about the spread between ROIC and have. If you have a high RoIc, chances are it's going to be high compared to your WAC. And so basically, to say that in layman's terms, investors value dollars of earnings higher if a company is more efficient in creating new earnings. So that's what return on invested capital is trying to basically measure for us. If Microsoft earns a dollar in profit, if it reinvests that dollar into its business, how much can it earn from that dollar? And so that's going to determine how much it can grow into the future. So a couple of things with the ROIC, I think the way it's calculated on a lot of websites is bowl.

Andrew:

If you really want to start to learn it, you got to open up a textbook and figure out how to calculate it. The other thing I'll say, and it's really powerful from two fronts. First is if you see it declining, going down, it can signal trouble from a business in multiple ways. Because if a business is losing its profitability, death by 1000 cuts, you can start to see that in the ROIC. Or if a business is overreaching, maybe they're desperate for growth and they're buying other companies, other businesses taking expensive new projects that are not going to be very efficient. That's where you'll see show up in ROIC as well. So I like to look at ROIC, and if I see it start to decline, really understand why is that happening. And I think it can start to help you identify when a business's moat might be eroding or they're just facing so much competition, or the industry itself is just not as in demand as it was before.

Andrew:

I think the ROIC can be super powerful from that perspective, from a risk management perspective, as well as all the other great uses for ROIC. What kind of uses, maybe do you have for ROIC or ways it can help investors?

Dave:

Well, I think the way that you explained it, I think is great. And I think really the only thing that I would probably throw out there is when you're looking at companies and their roics, again, go back to the industries that you're looking at and understand that the different kinds of businesses will have different kinds of ROIC. And it kind of comes down to capital light versus capital intensive. And when you think about companies that cost them a lot of capital to generate revenues, those will tend to have lower roics. Where you think about a company like Microsoft is a really good example of this. When you think about Microsoft and what it is that they sell to people, they created it a long time ago and they continue to invest in it to make it better. But the amount of money that they have to spend relative to creating the new product is minimal compared to what it was 50 years ago. And so every dollar that they create from that product is that much more profitable, which allows them to go ahead and spend that free money or extra money on either making that product better, or trying to figure out a better way to make what they're doing even better, or find something else that they can do and expand kind of their market or their basket of things that they offer people.

Dave:

Perfect case in point of that is them recently purchasing Activision for, what was it, 60 some billion dollars. Nice chunk of change they dropped on that to buy that. But that would not have been possible without the advent of all the cloud computing that they're doing, as well as all the Microsoft office products that they created all those years ago. With Bill Gates back in the. Without those products and all the new innovations that they've created on those, that's allowed them to have really high roics because they generate so much free cash flow and profitability from their investments in those products, gives them the freedom to go out and buy a company like Activision to complement what they're doing. And who knows what they're going to do once they integrate that into the gaming system they already have, the possibilities are endless. And that could really, really spur a company like Microsoft even further into the future. And so I think you really have to take into account what the business model is and what it is that they do, and then also kind of take into how ROIC functions.

Dave:

Sometimes you will see companies with roics that fall because they're reinvesting faster than they're growing their profits in the hope that will leapfrog the company forward in a few years based on the investments they're making now. And I'm talking about Texas Instruments, that company. If you look at just the numbers and don't understand the business. You may think this is a red flag, but when you understand that the capital part of the ROIC, which is the denominator, is the number that is growing faster than the return or the operating profit that they generate, and when that happens, then you get a dislocation and you see the ROIC drop. But it's based on the fact that they're spending money to earn more money in the future. And so that's where understanding the business model and really kind of understanding it. But the value of a company and ROIC go hand in hand because you can't have. Apple has to invest to grow.

Dave:

The greatest company, biggest market cap in the world still have to invest to grow. If they don't, they die. And so that's where ROIC is so critically important. And ignore it at your peril, I guess, is the best way of putting it.

Andrew:

What would be an example of a company that goes in apparel? It doesn't have to be a company, but like a situation where a company doesn't care about their ROIC and free fall, and so management is ignoring that, how does that turn into bad scenarios for shareholders?

Dave:

It could be. Well, ultimately, it will lead to destruction of value for shareholders. And it's one thing for it to be a one time thing, or maybe a few year trend because of a huge acquisition or maybe a huge capital expenditure to try to go into a new industry or build a new technology or product. But when it's a continual, long term, gradual decay or decline, then eventually it becomes a situation where the company has to start eating itself to stay afloat. It has to start selling assets, it has to start doing things, cutting corners on their products because they are losing profitability. And so they have to figure out a way to try to stay afloat and stay alive. And I can think of a couple of payments companies recently that made monster acquisitions that did not work out, and they just did a poor job of integrating them, where another company in the same genre made a big acquisition and has done really well with that acquisition, and they did a really good job of integrating. And because of that, those other two companies have very poor returns in the market over the last four or five years.

Dave:

And as a matter of fact, one of them have sold off the asset that they bought, 45 billion for pennies on the dollar, and another one is in the process of doing the very same thing. And if you looked at the ROiCs of those companies prior to the acquisition, their RoICs were in the 1012 range, not huge, but good. And now, if you look at them. Their roics are like two, four, five. And that's well below the cost of capital for that company, for those companies. And that's why they're destroying shareholder value. The CEO for one of the companies lost his job. The other one probably will.

Dave:

Certainly should. And so when you see those things, those are red flags for investors to run for the hills, because unless they turn that around over a long period of time, it's just going to destroy the value of the company.

Andrew:

Yeah, that's scary thought, but it really can happen in multiple different ways. Like you said, business can cannibal itself. It can not grow as fast in the future. Lots of bad, bad things. All right, so maybe we can wrap this up by talking about growth and value. I don't know where science and art plays into this, per se, but you wonder if, is there not saying this as an assumption or. I'm not trying to say that this is true, but do you think there's maybe less science in the growthier kind of investors? And is there maybe more of an art for the growthier investors and with value, are there value investors that are more sciency than art? How do you kind of see that and how should investors think about it if they are deciding between growth or value?

Dave:

If you held my feet to the fire, I guess I would probably say that if I had to put numbers on it, I would say growth is probably 70% art, 30% science, and value is maybe 50 50. And I guess that's kind of how I would feel about it. I feel like growth. If you're thinking about growth investing, you're focused way more on the operations of the business and the future prospects of the business than you are maybe necessarily worried about the balance sheet per se, where I feel like value investors are far more interested in the financials of the company, the financial health of the past, and how that can do in the future. Whereas I feel like growth investors are more focused on what are you going to do for me in the future? As opposed to what have you done for me lately?

Andrew:

Do you think some of that has to do with the life cycles of the businesses?

Dave:

Yeah, absolutely. Because you think about a growth, investors wouldn't touch a company like Crowdstrike with a ten foot pole. Because a value investor. Yeah, thank you. The value investor. Yeah, the value investor wouldn't touch that with a ten foot pole. It's losing money, it's very speculative. The free cash flow is kind of hit or miss.

Dave:

And if you look at trying to value the company, it's really hard to do because of those things. It's in growth mode. Every penny that the company makes goes in to try to generate more growth, and they've been very successful at it. And so for growth investors, they see all those reinvestments, they see the market opportunity that they're going for, and they see the continual revenue growth of the company even as they continue to get bigger. It's kind of defying gravity a little bit. And so those things would lead you to not really care too much about what's on the balance sheet. I don't care. Maybe not caring is maybe too strong, but it wouldn't be a real big concern for them.

Dave:

Whereas a value investor will look at it and go, their accounts receivable or their accounts payable is huge and they don't have enough cash to cover any sort of shortfall. And that would be a concern, a red flag for a value investor. And so that, to me, I guess, is kind of how the art and science of those kind of commingle, if you will. What about you?

Andrew:

I would say, again, at the risk of generalizing, I think the value kind of businesses, the more mature businesses in general, have a better chance of continuing to do what they do. So they might not be able to ten x from here like Crowdstrike would, but their chances of continuing to grow at a decent rate are probably very high, whereas with the growth side, not that it's a gamble, but there are a lot of things that could come their way that would throw them off the path. And so maybe with a lot of growth names, it's not as certain that they're going to achieve what they're trying to do versus a more mature name. And so when a value investor looks at something like a deteriorating balance sheet, knowing that, hey, there's not going to be some huge payoff in ten years to bail us out of this, that's why they get more concerned over things like balance sheets and capital allocation and things of that regard, because it is an important piece. Again, not to say to your point, not to say balance sheets are not important, but there are different time horizons and different business realities and the different ways that they affect the stock prices of those stocks. That's kind of how I would try to look at it from a beginner's viewpoint.

Dave:

I think that's a great way to look at it. So are there any situations where you feel like maybe growth and value can combine? How would one kind of look at that? Through the lens of arts, science and valuing a company.

Andrew:

Yeah, I mean, that's what I'm trying to do all the time, right?

Dave:

Every day. Every day I'm hustling.

Andrew:

To me, the way I try to approach it is I have a science to it in the sense that I'm not going to pay 70 times a company's earnings pretty much regardless. I don't know. There's got to be some crazy insight I have to make me comfortable doing that. And I feel like I've talked about this before many times, but as you get kind of further to that boundary of like, how much am I willing to pay? It can start to get gray. And to me, that really depends on the business itself, and that's where the art of it comes in. But I do believe you do have to be disciplined if you're trying to do it from a value investor kind of standpoint with businesses that have a higher probability of continuing to do what they do. I think you do need to be more strict on the science part. And so for me, I'm always running the valuations on anything I buy so that I'm fully aware of what I am paying, what kind of risks I'm taking.

Andrew:

Not to say I won't take them, but to be aware of what they are and to understand where your portfolio is in that spectrum. To me, that's important. How do you try to do?

Dave:

Well, you know, I think Warren Buffett probably cited best. You can't have value investing without growth investing. You have to have growth in any sort of investing that you do. If you're buying a company that's only growing at the rate of GDP that it operates in, you might as well just buy a bond in that country and call it a day because it won't generate enough revenue over a longer period of time to be worth the return on investment that you make on it. I guess the way I try to look at it is kind of along the same lines as you do. I try to think about the science part of it. I'm not going to pay 75 times for earnings for prudential. I'm just not going to.

Dave:

And I try to have limits. But like you said, there's gray, and that's where you find these great companies like Costco or visa that maybe push the boundaries on that a little bit simply because they are superior businesses. It doesn't mean that it's worth paying up, so to speak, for every company. And that's a myth that's kind of out there about Buffett. There's been some research recently that shows that he's only paid 15 times earnings for all the companies that he's bought, including Apple. And his greatest investment, he paid less than 15 times earnings. So kind of trying to keep that in the back of my mind when I'm looking at companies, I may not be as patient as he is, for sure, but trying to understand that I need to buy a company that has a future and has growth in it, potentially, but also understanding that what has happened in the past, especially if the CEO is still at the helm, if so and so has been running the company for the last nine years, and the company has done well and nothing is broken, so to speak, in the business model, chances are it's going to operate in roughly the same range going forward. And so if you understand that part of the science of understanding the financials of the company and merging that with what you understand about the business model, what products and services they offer and what kind of potential growth those offer, I think that's probably the myriad of nirvana when you find investments that can kind of fit both worlds.

Dave:

But it's hard. It's really hard. It takes a lot of work and it takes a lot of effort to try to uncover those, for sure.

Andrew:

And some patience.

Dave:

A lot of patience. Mucho, mucho patience.

Andrew:

Yeah, I think that's all spot on. All right.

Dave:

Well, with that, folks, we will go ahead and wrap up our first live show together. So hopefully you guys enjoyed our conversation for today. Thank you for listening. And with that, we'll go ahead and sign off. So you guys go out there and invest with a margin of safety. Emphasis on the safety. Have a great week, and we'll talk to you all next week. Bye.