IFB337: Investing with a Margin of Safety: A Strategic Approach

Dave [00:00:00]:

All right, folks, welcome to investing for Beginners podcast. Today we have episode 337. Today we are going to answer three fantastic questions we got from Spotify. Speaking of questions, if you have questions, you can send them to Spotify. Of course, you can also send them to us at newsletter@envestingforbeganners.com and we can answer them for you here on the air so we can help you out. So with that, let's go ahead and dive to the first question. So is it better to put your money in a high yield savings account or an index fund? And this is from pistol Pete. So, Andrew, what are your thoughts on.

Andrew [00:00:34]:

This great, excellent, excellent question. The answer, I think, depends on what you're trying to do with the money. To me, the question whether to save or invest depends on your time horizon. And to me, whether you're saving or investing is going to determine if you should put it in a high yield savings account or an index fund. So, Dave, how do you think about that idea?

Dave [00:00:58]:

100% agree with your assessment. You need to really decide what you're trying to do with the money, and that can go a long ways towards where you want to put it. So, for example, if you were saving money for a house, which one of these would you use?

Andrew [00:01:13]:

Yeah, savings account, for sure.

Dave [00:01:16]:

What about if you are saving for a down payment on a house?

Andrew [00:01:23]:

Okay, I'll keep in the same answer.

Dave [00:01:26]:

Okay. How about if you were going to buy a car in three years?

Andrew [00:01:32]:

Same answer. All right.

Dave [00:01:34]:

What about if you wanted to save for your retirement in 25 years?

Andrew [00:01:38]:

There you go. Now we can start talking about investing. All right. Yes.

Dave [00:01:42]:

I think you really have to decide where you want to go and how you want to put your money. If I was saving for an emergency fund, I would never put it in the stock market. Would you?

Andrew [00:01:53]:

I mean, I have before, but I'm not saying that's the smartest move.

Dave [00:01:57]:

Right? Why is that? Why would we not want to put one of these maybe more short term goals in the stock market?

Andrew [00:02:05]:

Yeah. I mean, if you've listened to our show for any length of time, you've heard how ra stock, stock stocks we can be. But that's always in the context of you having a long enough time horizon to let your investment ride the volatility and the ups and downs of the market. If you look over the history of the market, which spans over 100 years, we've had many decades where the market's been really good, but then other decades

where the market stays flat or even loses money. And so because of that, and because you get so much money, swish swashing all over, in and out of the market all the time, you really shouldn't put money in the stocks unless you have 15 2025 year time horizon at least, because you do have a chance of losing money. Even if you pick the best company in the world, you could still lose money if your timing is off, if your time horizon is too short and you get caught in the waves of the wishy washy market. The key of the stock market is you're investing in businesses, you're investing in the economy, and that will grow over time. But in order to get the full value of that, you have to be in there long enough where you're getting the value from the growing of the economy, and not because a couple of dudes on Wall street got really excited about a stock.

Dave [00:03:25]:

So here's a couple of other, I guess, questions. If you're investing for the long term, why would you want to choose an index fund over a high yield savings account?

Andrew [00:03:34]:

The returns are going to be much, much higher for an index fund unless interest rates are at like 11% or something like that, in which case I would say the upside for stocks would be even higher. But just from a numbers standpoint, yeah, nine times out of ten, you're going to win in an index fund versus a high yield savings account over the long term. And maybe that's even 99 times out of 100. But you do either have to be in an index fund, so you're buying the entire market, you get the exposure of the stock market, or you're picking the right stocks. And there are stocks that go to zero. There are stocks that stay flat for a long time. So you do have to be careful if you do it that way, too.

Dave [00:04:16]:

Yeah, that's totally true, I guess. Another question that kind of comes to my mind. Let's say that you want to invest in index funds, or maybe you're wanting to invest in individual stocks, and maybe you can't find anything to pull the trigger on. Where would you keep the money in the meantime?

Andrew [00:04:38]:

I'm very passionately in the dollar cost averaging camp, and I'd be curious to get your take, too. But for me, I just want to set a habit of always putting money into the stock market. So if there was ever an instance where I felt like I couldn't find a stock that fit my criteria, being good enough to buy, then I feel like an index fund is a great way to go about putting money into the stock market. And we just always have to remember it's not about one investment. It's about the habit that you build that will build your investment portfolio. It's a big picture. It's not just a single snapshot. So what about you? Do you come across that a lot and what do you do in those situations?

Dave [00:05:24]:

I don't come across that a lot, and I do the same thing that you do. I'm a big fan of time in the market versus trying to time the market, and I rarely have trouble finding something that I could put my money into. A lot of times it may not be a new idea, but things that are already in my portfolio that I either want to add more to, or maybe the stock price has dropped and I want to take advantage of that dip. I think having money in the stock market is really the best way to do it. And keeping the money on the sideline or the purpose of investing, I think, is not a way I choose to go. And I wouldn't recommend people go that way either. I think the idea of having a habit and creating that habit and continuing to stick with that habit is the way that we can grow our wealth. Now, if you come into money, if you have an opportunity where you get maybe a super huge bonus at work and those kinds of things, those are different situations and you can kind of adapt to those as they come up.

Dave [00:06:26]:

But I think trying to consistently, regularly put money into the market will help build that sandpile, if you will, and can grow that over a long period of time. And I say this all the time, but water dripping on a stone will eventually make that impression. And you just keep grinding away and putting that in there. It will in the long term benefit you. And I think you also have to think about the opportunity cost of if you keep the money on the sideline, unless you find the next Google or Amazon, you could miss out on returns because you are waiting for the next big thing. And by doing that, there's an opportunity cost of a loss of time in the market. And I'm not talking about five days here, I'm talking, you know, or maybe even years waiting before you pull the trigger on something. Those kinds of things can really set, you know, unless you find the next Amazon and it goes to zero to 100 in a month kind of thing.

Dave [00:07:30]:

Other than that, I think trying to consistently put the money in, like you were suggesting, dollar cost averaging, those are our friends as individual investors and just consistently doing what we need to do, that's the way I try to look at.

Andrew [00:07:41]:

Yeah, I feel like that's really great advice. It's exactly how I try to look at it, too. And I think it doesn't really need to be more complicated than that. So I hope people take that to heart.

Dave [00:07:51]:

Right, exactly. What did Einstein say? Make it as simple as it needs to be and no simpler.

Andrew [00:07:55]:

Yeah.

Dave [00:07:55]:

All right, let's move on to the next question. So this is from Rachel. Why is DNA or depreciation and amortization, as in depreciation and amortization on the cash flow statement often different from the depreciation and amortization on the income statement? So this is a great question, Rachel. Andrew, do you want to take a first stab at this?

Andrew [00:08:14]:

Yeah, let's do it. Stock pickers, advanced class here. Let's tackle it. So maybe you want to talk real quick. If stock pickers maybe are into net income or cash flow statement, but they haven't really learned about DNA, how would you describe that from a bird's eye view?

Dave [00:08:33]:

I think the easiest way to think about depreciation and amortization. Depreciation is things you can touch, and you're spacing out the payments for those over a longer period of time. The expenses for those amortization are things that you can't touch, and you're doing exactly the same thing, but for things you can't touch. So, depreciation, you can think of a building or a computer or a car or a truck or something like that. An amortization would be like software, something that's created that you can't physically touch, but obviously does generate money. And so I think that's the way that I try to think about them. Do you think that helps clarify it?

Andrew [00:09:15]:

Oh, yeah, for sure.

Dave [00:09:16]:

Okay. All right, so both of these items live on both statements. And so depreciation and amortization are expenses on the income statement, which means that they're like a cost. So if you have a depreciation and amortization on your income statement, it reduces your income so that the next line lower on the statement is actually less. So it's actually an expense on the income statement.

Andrew [00:09:43]:

Yeah. And I guess as a practitioner versus somebody who just read it in the textbook, what's frustrating is not every company will tell you their depreciation amortization. They have to show it on the cash flow statement, but not all of them show it on the income statement. And so I don't know the exact reason why. Maybe David can shed some light into why it can sometimes be different between the income statement and the cash flow statement. But to me, if it's not required to be on the income statement, and it's not because a lot of companies don't put it, then it makes me believe that there's no standardization. So I don't want to say to pick and choose how to classify things, but maybe if it's spread out in different parts of the income statement versus the cash flow statement, it's all in one place. That could be a reason.

Andrew [00:10:30]:

That's kind of how I look at it. What about you?

Dave [00:10:33]:

Yeah, I look at it very similar. I did come across some information a little while ago. I don't remember the exact term for how the income statement is written, but I know that the cash flow statement is, they use rule accounting to calculate the numbers for that. And I believe the income statement is a different kind of accounting. And so sometimes that can lead to a discrepancy from one to the other. The other part of it, too, is we are not privy to the accounting journals that the companies use when they calculate all these numbers. And so sometimes they may put depreciation on the income statement in another line item, or they may have an offset in the line item that we don't see that costs. It adjusts the number, and then when they do it on the cash flow statement, they may add that number back in.

Dave [00:11:23]:

And we're not privy to the ins and outs. When you think about accounting, without getting into all the nitty gritty of details, when there's a revenue, there's always a cost, there's an offset for everything. And so when you're thinking about the income statement, there's always a plus and a minus to offset to make sure that everything balances or equals to a certain extent. And the cash flow statement is the same. And so we don't see all the little details that will be in there, and that's why they can be off. And it can be super confusing. Like Andrew said, a lot of companies, I would say, if I had to throw a number, 85% to 90% of most companies that report don't show depreciation and amortization on the income statement. And so it can be super frustrating and confusing, because really, the only way you can tell what the number is is by looking at the cash flow statement.

Dave [00:12:16]:

So if you're trying to calculate the EBITDA margin, which I'm not a big fan of, but if you're trying to calculate it, those are two big numbers, you need to calculate it. And the only way you can find them is on the cash flow statement. Sometimes you can find them in the notes if you use our friend control f and hit that, they may have a breakdown of depreciation and amortization in the notes, but not every company will do that. The GAAP accounting rules apparently don't. I haven't read them thoroughly, frankly, but I'm just assuming because the companies don't disclose that information if they don't have to, they won't. And so a lot of them won't. And so it can be confusing. Yes.

Dave [00:12:55]:

Don't beat yourself up, Rachel. If you're like, I have no idea why these don't match or whatnot, I think the more important idea is just understand the direction of the depreciation and amortization and really understand the impact that has on the earnings and the cash flow of the business and just kind of measuring if they're being efficient with those numbers. That's really more important than really having exactly this number match up with that number.

Andrew [00:13:21]:

Yeah, that's really good advice. I don't see it as something that's nefarious if you think that way. I feel like it can get confusing sometimes to balance out operating income. If you're a business and you have a retail segment, and let's say you have like a software segment, your depreciation, amortization for each segment is going to be two different things. And then if you have a third segment, maybe that throws another wrench into the loop. But they all got to go down to one operating income number, right? So you wonder if that's another factor that makes it just to kind of shed light into why some of these things are, because I know if you're a beginner, it can be like, well.

Dave [00:13:59]:

Why doesn't it match? Yeah, I guess the last thing I would say about this is if you look at the income statement, you will see in the expense section for operating income, SG a sales general and administration, or R D, the depreciation and amortization. The companies can put each of those line items as part of those line items. So in other words, they can assign, if somebody's working on R D, they can assign not only just the payroll for those people, but they can assign them depreciation and amortization. They can also assign them stock based compensation, which is another non cash expense that is included in the cash flow statement. And they don't list all those out separately, individually, because it would make the income statement 1000 pages long. Right. So they don't include all that. But when you read the notes of the financial statements, sometimes they will tell you these items are included in the R and D cost, for example.

Dave [00:15:00]:

And so it can get a little confusing. So try not to get lost in the minutiae of why did they have depreciation and amortization and r and D. That's not really important. The more important part is understanding how it impacts the business and the growth and the cash flow of the business.

Andrew [00:15:16]:

Yes, very well said.

Dave [00:15:18]:

Yeah, try not to bog down in accounting. It can drive you nuts. All right, so let's move on to the last question. Hi. Thanks for a great podcast. My question is if for a company's fundamentals and financials are looking great, it has good dividends as well, but the stock price hasn't increased much in the last five years. Must be talking about my portfolio. What are your thoughts on this great question?

Andrew [00:15:42]:

That's a very good question. I think it highlights the idea that, well, there could be many possibilities, obviously, but I find it easy to classify between maybe one or two. One possibility is if you buy a stock when it's really expensive, and what I mean by really expensive, let's say you paid $100 and you got one dollars of earnings, you paid like 100 times earnings. Then I don't care if your business grows 30% for several years. If you pay too much and you don't have the same number of buyers moving down the line, you're probably going to end up with a stock price that doesn't move much. That's simply because you overpaid. All of the good news was already priced in, it was already paid for, and people already expected all those good news. So as all the good numbers came out, everybody knew it and there was no big uptick.

Andrew [00:16:33]:

You didn't have any more buyers because all the buyers were ready in because they knew how great of a company this was. The other category would be maybe there's a business where it might be doing good now, maybe the next two, three years. But ten years, 15 years down the road, there could be something coming that could challenge a business. And so investors are unsure about the future of a business, and that can be problematic. A lot of the car manufacturers today, Ford, Toyota, GM, cyclical industry, so they tend to have low pes anyways. But with Tesla coming screaming around the corner, taking all this market share, it does affect the stock prices of those companies, even if they do pretty good with their growth rates.

And so that's just one small example of different ways. And I think a lot of that just kind of goes to that great book by Mobison, expectations investing.

Andrew [00:17:32]:

We're talking about the expectations of failure and the expectations of success. And those things are what can make the financials of a stock divorce from the actual stock price. What did I miss there? What else can this person take away from that?

Dave [00:17:47]:

Well, I think that was a great explanation. Sometimes, to be blunt, the market may not recognize how well the company is doing. There are companies in the stock market that are overlooked. They don't get a lot of press. Maybe they're in a niche that is overlooked, underappreciated, could be in an industry or a sector that maybe is unloved. And so maybe that company, one particular company, is doing really well financially. But because the overall sentiment about that particular niche or market is not positive, underlooked, overlooked, negative, assign any adjective you want. It cannot appreciate because it's not going to get a lot of activity.

Dave [00:18:30]:

Not a lot of people are going to go out and buy it, which is going to cause the price to go up. Because the more excited people get about a company, the more the price gets bid up. And that's how you can see price increases in an investment. Sometimes part of it can be you might have to wait. Sometimes you just have to wait for others to see how awesome this company really is. I know that I don't play in this field much, but I've been looking at it a little bit more recently. Smaller companies, micro caps, small caps, a lot of those can go unnoticed, and a lot of them don't get any coverage. In other words, analysts don't look at them.

Dave [00:19:07]:

So the big firms that could be out buying these companies don't because they're so small and they don't get any coverage. And so sometimes there's little to no activity on those companies for a very long time. And so if that's the circumstance, it could be the most awesome business in the world. But if nobody knows about it and nobody else is buying it, the price is just going to sit there for a while. And that's part of the, I guess, illiquidity of owning those companies is because you don't see a lot of activity, good or bad, the price doesn't move much. And so that can be part of why you see that happen to different companies. The one thing I was thinking about, maybe we could talk a little bit about, you were kind of mentioning the expectations, what can drive a company's stock return to do better? What are your thoughts on that?

Andrew [00:19:55]:

Oh, man, where do I start? I guess you'll have to rein me in here, right? It's interesting because even in the finance industry, where we try to put numbers to these very abstract concepts like, how much should you pay for a stock? The over 50% of a stock's value is in its terminal value, which means the value of it after, let's say, ten years, which is different from the value of all the cash flow it generates in, let's say, the first ten years. And so that terminal value can be based on how people perceive the very long term prospects of a business. So something like Walmart or Costco might not have much change in the next 10, 15, 20 years, and so they might have a higher terminal value compared to something like, I think people forget. Before Apple became Buffett's big investment, it was classified as consumer technology hardware. And those tend to have really low multiples, tend to be pretty cheap compared to their earnings, because the usual cycle of those is that people figure out the technology and then they bid it down. And that's why CD player goes from, it's obsolescent. Because technology, hardware is continually, like, cannibalizing itself. And so if you're a business that is in that value chain, a lot of times you can see the stock price always cheap, because the expectations are, you might be doing good now, but in 510 years, when technology comes to disrupt you, you're not going to do so hot anymore.

Andrew [00:21:36]:

So that's kind of a couple of examples. Do you have a couple more?

Dave [00:21:39]:

I guess one thing I was thinking about was kind of the idea of value being pulled forward. You kind of mentioned that in first little statements. What did you mean by that?

Andrew [00:21:48]:

Basically, the expectations, if we're all buying the stock, expecting it to grow 15%, and let's say you bought a stock because you wanted 15% growth, but let's say they deliver you 13%, but you're always wanting a stock that delivers you 15%, well, you might jump ship and go to the shiny object at the greener across the street that is growing at 17%. So you get these people hopping back and forth. That could be one way that the expectations set where the price ends up going. So when you get a group of those types of individuals, like growth stock people, they can be very fickle sometimes. And the other thing is, I don't know. I'm struggling to quantify it. Exactly. I understand the concept.

Andrew [00:22:34]:

I'm having trouble explaining it. So maybe you can.

Dave [00:22:37]:

Okay, I'll try. So the way that I look at it is, when you think about. I think a good example, an easy example that we can all relate to is if you think about what happened during the pandemic, a lot of the companies, especially the ones that were more groundbreaking technologies or were going to fundamentally change how we do things. A lot of the value the company was starting to generate, the people were pricing in the expectation that that was going to continue or be this awesome five years from now, as opposed to where it is today. So if you look at Zoom, if you look at Peloton, if you look at PayPal, those are just three that I can kind of think of off the top of my head. Those prices of the stocks were bid up because people were expecting, the companies were growing really fast at the time, and so investors were expecting that to continue and either not even just continue, but to accelerate and to continue going forward. And so people were basically buying it on the anticipation that this 45% revenue growth that's happening right now will continue for the next five years. And so I'm going to pay now for that value that I can get in five years.

Dave [00:24:02]:

And so the way I looked at it was that's what they were doing, and that caused the prices of the companies to escalate very quickly. And I know that happened with PayPal, that the 25, 35% revenue growth that they were seeing during that period, everybody anticipated, myself included, that that was going to continue. And, oh, were we wrong. But that's part of the anticipation, is the expectation on the market, on Wall street, was that what PayPal was doing was going to change. And the revenue growth that they saw prior to the pandemic, which was good, but not awesome. Now, everybody's pricing that in because they anticipate that it's going to grow into that value as it goes along, and you're going to reap the benefits of that. And recently, Nvidia has also kind of experienced the same thing. Now, you can argue valuation, you can argue all these different things, but there's no question that because people saw this huge revenue spike, everybody jumped on board because they wanted to partake in that continuing acceleration because of AI and everything that's going on with that.

Dave [00:25:11]:

And they're anticipating that that revenue growth will continue. So they're willing to pay a higher price to get the value that they think they're going to receive in three to five years based on that value. At least that's how I kind of think about the whole forward idea. Do you feel like I covered that or encapsured that idea?

Andrew [00:25:30]:

Yeah, for sure. So kind of like the idea of compounding, allowing a business to grow into a valuation. I think that's something I kind of underappreciated when I first started as a stauntly value type of guy. Can you

explain that? Because that is the, I would say probably more often than not, the companies probably don't grow into their valuation, but every once in a while they do. So what does that look like?

Dave [00:25:56]:

Well, I'm not sure. I will do my best to explain it. So to me, it means that if I buy a company, and let's say that I pay $100 for it, and I think that the value of that company in the future is going to be $150, I'm willing to pay $100 for it to grow into the $150.

Andrew [00:26:17]:

Right.

Dave [00:26:18]:

And so that's my expectation, is that it's going to be worth $150 a year from now. And so I'm willing to pay a higher price today, $100 for it to get to that $150. And that's based on what I think the company is going to perform as well as how the market will react to their performance.

Andrew [00:26:36]:

Yeah. So there is a lot of power in that exponential growth. I don't know why I get this visualization out of my head, but if we were to take like a ruler and we're just measuring the growth of a baby plant, and you measure a couple of inches, you measure a couple of inches. So the market's like putting a ruler and saying, okay, you got a couple of inches more, a couple of inches more. Every once in a while, though, you get a plant that grows exponentially, it shoots up. And so all the previous rulers that were measuring whatever growth they expected, it shoots way past that. And so even if your ruler was really tall, if the exponential growth is even bigger, then it pays off. I think the problem that we run into, I ran into it, too, with Domino's.

Andrew [00:27:21]:

I still get mad every time I drive by one of their trucks. But the problem is exponential shooter, outgrowing a really tall ruler is not as frequent as I think a lot of investors like to hope. And it makes it hard to play that game.

Dave [00:27:37]:

It really does. And it can get into trying to time the market and trying to anticipate when you think that growth is going to slow down or stop. And that's why that kind of investing takes a lot more diligence and a lot more, I guess you have to pay attention. You have to really stay on top of what it is that you're trying to do

with that particular company, because if you don't, then you can get burned really bad. For me, that's just not a game I like to try to play. I've tried it a couple of times and I've gotten burned both times.

Andrew [00:28:14]:

The hope springs eternal. There's always another opportunity.

Dave [00:28:17]:

That siren song, what is that saying? It's better for people to think you're a fool than to open your mouth and remove all doubt.

Andrew [00:28:27]:

Well, I fail there.

Dave [00:28:28]:

Yeah, me too. All right, folks. Well, with that, we will go ahead and wrap up our conversation for today. I wanted to thank everybody for taking the time to send us those fantastic questions again. You can do this either through Spotify, you can do it on LinkedIn. You can also do it on Twitter, or you can send us an email at newsletter@einvestingforbeganners.com we're here and happy to help in any way that we can. So with that, we'll go ahead and sign us off. You guys go out there and invest with a margin of safety.

Dave [00:28:55]:

Emphasis on the safety. Have a great week, and we'll talk to you all next week. Bye.

We hope you enjoyed this content. Seven steps to understanding the stock market shows you precisely how to break down the numbers in an engaging and readable way with real-life examples. Get access today@stockmarketpdf.com until next time have a prosperous day. The information contained just for general information and educational purposes. Only it is not intended as a substitute for legal, commercial, and or financial advice from a licensed professional review, our full disclaimer@einvestingforbeginners.com.