# IFB339: Applying Base Rates to Stock Picks: Insights from Michael Mauboussin's Expertise

Dave [00:00:00]:

All right, folks, welcome to investing for Beginners podcast. Today we have episode 339 again, Andrew and I are live. So we are talking to each other face to face, right across from the table from each other. So no fistfights, just lots and lots of fun. So today we're going to excite you by talking about base rates. What are base rates? Well, good question. We're going to talk about them. So Michael Mauboussin wrote this great paper back in 20, 14, 15, sometime in that range, talking about base rates.

Dave [00:00:31]:

And it's 152 pages long. It's a PDF you can download off the Internet for free. And it is something that I refer to almost every single year because it's that important. And the ideas that Michael writes about in the paper are very critical to helping you really understand investments and how to buy and choose different investments. So with that, let's dive in and talk a little bit about base rates. So I guess maybe before we really dive in, what are base rates? So people are listening to us going, Dave, what are you talking about?

Andrew [00:01:04]:

Yeah, I like to think of it like ODs. I love playing poker. Have loved playing poker since I was a kid. And so if you're a Texas Holden player and you have a hand and you can see what cards are on the table, you generally know, all right, this hand, I have better odds, better chances of success versus a different hand, things might not look good, I might get really lucky, but maybe I don't want to play that hand every single day. And the stock market can be very similar. We have stocks that for whatever reason, you'll see just take off to the moon. And sometimes it's warranted and sometimes it's not. But that's the weird thing about business, is you do have stocks that defy all odds, for lack of a better word.

Andrew [00:01:51]:

But overall, if you're trying to look at the entire universe of stocks, there are numbers that kind of explain where stocks generally what they generally do, what businesses generally do. And so the base rates are trying to tell you that, okay, on average, stocks might do this or a business might do that. And so if we can know what those averages are, we can set our expectations as stock pickers to say, okay, I'm not going to assume that this thing's going to become the next Microsoft or something. Instead, maybe I will try to invest with a margin of safety, understanding that even if things don't work out like I might like, I'll still get good returns because I'm respecting the base rates. That's kind of how I look at base rates. How about you?

Dave [00:02:38]:

I kind of liken it to. I think that's a great definition, by the way. I liken it to the laws of gravity. Sooner or later, the laws of gravity will take a hold of every single object that we know of, but there will be times where the rocket will allow it to escape velocity, generate enough velocity to escape the laws of gravity, but eventually it will return. And so to me, it helps me visualize, yeah, this company may be going crazy right now, but eventually gravity will take a hold and it will return it to air, quote, to normal performance at some point. And that's just the way capitalism works, and that's the way the stock market works. And I think part of what Michael Mobison was trying to teach was that kind of idea. That's the way I interpreted it anyway.

Andrew [00:03:30]:

Yeah, I love that you do get those stocks that rocket ship up and they do defile.

Dave [00:03:35]:

Yes. Yes. Tesla for a long, long time was definitely one of those.

Andrew [00:03:39]:

Yes.

Dave [00:03:40]:

All right, so Michael breaks it down the book into eight chapters, and we're going to talk about three of them today. Just to kind of give you a snapshot of kind of the things that he's trying to teach and what kinds of takeaways you can get from this book as you're reading through it. It's not super heavy, there's not much math to it, but there's lots of detailed explanations of different things that are going on. And it really helps you understand the importance of each dynamic that he's talking about related to base rates. So he basically breaks it down into categories that affect the performance of the company financially and how that can affect the stock returns of the company. And arguably, to me, probably the most important one is the sales growth. And that's the first chapter that he talks about. So when he's talking about sales growth, what does that mean? What is he talking about?

Andrew [00:04:35]:

Yeah. So we're really looking at the top line of a company. It is really the driver of long term growth. You can grow a company in many different ways, but you have to start with sales growth on an income statement. It is the very top line. So if I'm a lemonade stand and I'm collecting $10 per lemonade, maybe.

Dave [00:04:55]:

Wow, this is expensive lemonade.

Andrew [00:04:57]:

It's organic kombucha. Saves the planet all in one. That $10 that you pay me is going to be sales and then expenses and everything come out until we get to a profit. And so the end of the day, we're trying to buy businesses that can grow their profits. But in order to sustainably grow your profits over the long term, you have to grow your sales. There's only so much of a juice that you can squeeze, and it's the same with sales and profits. And so that's why not just Mobison. But I know there's been other teachers of finance who have talked about sales growth being the most important driver to business growth.

Andrew [00:05:38]:

And that's why we start there. And I think that's why, to me, this whole thing is just filled with great nuggets that you would just never think right until you had somebody who could look at all the data and interpret it for you. But the biggest takeaway for me, the biggest section was the sales growth, because it helps me set my expectations when I'm buying the stock about how much it could realistically grow over, let's say, ten or 20 years.

Dave [00:06:06]:

Yeah, exactly. So why is sales growth so important? What does that do?

Andrew [00:06:11]:

How would you think of it?

Dave [00:06:14]:

I look at it as the foundation for every single thing that the company wants to do to continue to grow. And if you don't have sales growth, you can only cut costs if you bare bones to the point where you're the only person working for the company. And if that doesn't generate a profit, then you need to generate more sales growth. I guess the way I would relate it is if we look at our own personal lives, when we look at our budget, we have two things we can do. We can either earn more income or we can cut our costs. And you can only cut the cost so much. You still have to have a roof over your head, you still have to pay for food, you still have to have insurance, car insurance, health insurance, still have to have Netflix. But once you cut it to those bare bones, then there's not a whole lot more that you can do.

Dave [00:07:05]:

You can only know in braden terms, you can only eat so much dirt and ramen, right? And at some point, something has to give. And so the other side of that coin or equation is revenue growth. And so a company that can grow their revenue faster than they can cut their expenses is what really sets the greats apart from each other. You think of the dominant companies over the last four or five years. They're all growing at huge numbers. Nvidia is what, the third largest company in the world now? Third or fourth largest company in the world now. And they've know a monster revenue growth over the last year or so. Microsoft, same deal.

Dave [00:07:45]:

Apple, Visa, Mastercard, UnitedHealth, Tesla, all these companies are all growing like weeds, and that revenue growth allows all these other things to become possible. Great reinvestments, dividend pays, buybacks, giving the CEO their huge bonuses. Maybe not a real popular one, but all those things are not possible if the company is not generating revenue. I mean, they may technically be possible, but not for profitable long range companies that we would want to invest in. Yes, I'm talking to you, snap. So just those kinds of things. I think that's really to me why sales is so important.

Andrew [00:08:24]:

So talked a little bit about why sales growth is important. What were some of the big takeaways? Because really, with each of these sections, Mobison runs the numbers for sales growth. He goes from 1950 to 2015, looking at thousands of stocks over this time period. What was your big takeaway from the sales growth data?

Dave [00:08:49]:

I think there are a couple of things. Number one is kind of the idea that sales growth cannot sustain forever, that there is reversion to the mean or aggression to the mean, and that when you're trying to value a company or generate some sort of prediction of what you think the company, how you think a company is going to do, you have to consider base rates. You have to consider what is air quote normal or what is a normal range for a company this size to grow their revenues at and for how long. Because when you think about the lifecycle of businesses in the early stages, they generally grow really fast. They are operating from a smaller base, so they have smaller numbers to improve upon every year. And as the company gets bigger, those rates generally will compress. So a company like Microsoft, which is the largest company in the world, right, can to expect them to grow at the same rate that Crowdstrike would grow at, which is a much smaller company, is not realistic. And so to me, the whole idea of these base rates is it helps you try to realize or put into words or paper what is realistic for a performance that you can expect for a company over a longer period of time.

Dave [00:10:19]:

I'm not talking like next quarter or a year, I'm talking five to ten years. And to me, that's what these base rates help establish. Maybe some guidelines to give you some reference. So if you're valuing a company, let's say you're valuing, I don't know, Cloudflare, and they're currently growing at 50% a year. If you project that for the next ten years and you look at those numbers, those are serious big boy numbers or big person numbers. Sorry. And so that can really illuminating to maybe this isn't possible. Maybe I need to kind of cool my jets on my enthusiasm of how great I think this company.

Dave [00:11:02]:

It doesn't mean that it's not a great company, but just to put that expectation that as it gets bigger, that it's going to continue to grow at a certain speed or size is unrealistic. To imagine. If you put a 30% growth rate on a company like Amazon right now, which is producing a little over 500 billion in revenue annually, to put a 30% growth rate on that over the next ten years, that's a really big company by then. Not saying it's not going to be a big company, but it's not realistic to expect that. So that, to me, was how base rates can be helpful and what I use them for. What are your thoughts?

Andrew [00:11:41]:

Yes, that's the takeaway I got, too. So it's interesting to see what he came up with. So he took 41,000 stocks, kind of snapshots of stocks. I only looked at the ten year period because he looks at one year, three year, five year. But when I'm looking to buy a company, I'm hoping to hold it for at least ten years. So if he takes the ten year range and you're looking at like 41,000 observations, most of the companies fall in the zero to 5% annual sales growth. So out of the 41 instances, 41,000, you have 14,000 company instances that are in zero to 5% range. So to me, that's really humbling to think that when I buy a stock, I'm hoping it grows revenue 8910 percent a year.

Andrew [00:12:31]:

But you're telling me the ODS say that the most likely outcome is zero to 5% per year. So it really, to me, put a clamp on expectations and understanding that if your stock only grows zero to 5% a year, don't be surprised the ODs are for that versus, like you said, 30% a year. The number of companies that did that, we're talking, if you want to take like the biggest base case, it was 45% a year, 133 out of 41,000.

Dave [00:13:05]:

Over a 60 year period.

Andrew [00:13:07]:

Yeah. Were able to do it.

Dave [00:13:08]:

So the odds are not in your favor.

Andrew [00:13:10]:

Not in your favor. And to your point about the small company, big company thing, the odds kind of shifted. But there were, I would say, kind of like we've said over and over again on the show, you have a better chance of a smaller company growing more than a big company, but you also have more safety in the big company in that there were a lot more smaller companies who failed to grow, whereas a lot of the bigger companies are able to keep going, but maybe not grow as fast as the group of smaller companies.

Dave [00:13:38]:

Right? Yeah, exactly. The other thing about that, too, is you think about the failure rate of big companies is infinitesimally small compared to the failure rate of really small companies. So the really small companies are more likely to go bankrupt or go out of business because of myriad of reasons than the monster companies. It's not to say that it doesn't happen. It absolutely does. But the odds of that happening are much, much smaller than they are with the much smaller companies. And I think you can take those two kind of ideas and help you really understand the majority of companies when you're valuing those companies. Now, this isn't to say that there aren't exceptional companies or companies that fall outside of these ranges.

Dave [00:14:28]:

And we've talked about some of those in the know, the Amazons and the Teslas. These companies have defied expectations for a very long period of time. But eventually the law of gravity will come and it will take a hold of the company and they will start to slow. They just have to. Otherwise, if you extrapolate those numbers out, kind of like what I was doing a little bit with Amazon, eventually, if it grows at those large numbers, at that pace for a long enough period of time, eventually it becomes the whole economy of wherever you're residing, whether it's the United States, Brazil, or the world. And so we would end up having to buy literally everything from Amazon, from our car insurance to our toothbrushes to our Netflix subscriptions. Everything would come from. So, you know, I'm not saying that won't happen, but the ODs of that are probably pretty small.

Dave [00:15:23]:

And so I think the biggest takeaway for me is really understanding how base rates work and trying to put a cap, as Andrew put it, on your expectations of how awesome your company is going to be. And not saying it won't be, but you always have to, I think, in the back of your mind, understand that it's going to revert to the mean. Maybe this is a good place for us to talk about that. When we're talking about reversion to the mean or regression to the mean. What does that mean?

Andrew [00:15:50]:

I like that little play on words. What does regression mean? Mean?

Dave [00:15:54]:

Yeah.

Andrew [00:15:55]:

So there's a couple of ways you can look at it. You can have a Business regress to the mean, and then you can have valuation regress to the mean. A lot of times they happen together, but not always. So let me talk about the valuation regression and the mean. If you look at, and I used to see this a lot, I don't know why it's not as popular anymore. Maybe I'm just not looking in the right places. But I used to have these charts where you show the markets, the stock market's price to earnings ratio over time. And so all the classic value investors will always say, you can look at over decades and decades and decades of the stock market's price to earnings ratio, which is just telling you how cheap or expensive the market is.

Andrew [00:16:35]:

And you can say, all right, if the market has always been around 15 or 17 and the market's at 25 or 30, eventually it will go back to the average. And that's kind of the idea. The reason being you have Mr. Market, where you have a lot of fear and a lot of greed. The market's made up of emotional people, and so you tend to have too much excitement on the upside, but then also too much pessimism on the downside. And so likewise, if you see pes at a ten, you might think this is a great time to buy stocks because we know over time the average is somewhere 1517. And so when you invest with valuation reversion to the mean in mind, you can sometimes pick up deals when the market's discounted because you understand that maybe there's just a lot of fear right now. Maybe there's just a lot of uncertainty.

Andrew [00:17:30]:

There's a lot of maybe people without jobs who can't put money into their 401K, whatever it is that's causing the market to be low in that time period. You can hope in reversion to the mean that things will become maybe mighty like they used to be. And so that's one way to think about reversion to the mean. You also have businesses that might revert to the mean, but that one, I think is a little less, I would never say like valuation reversion to the mean is a certainty. But with business reversion to the mean, sometimes you do get businesses that do revert to the mean, and sometimes they just don't, depending on the business. So how would you describe business reversion to the mean?

Dave [00:18:10]:

Oh, boy, that's a good question. I think the easiest way that I would look at it is when you look at different sectors of the market, there's always going to be a leader or two in the market, and then there's going to be other companies that are performing well, but maybe they aren't performing to the same level as the leaders. And then there's going to be kind of the opposite end of the spectrum. There's going to be laggards in the industry, so there's going to be people that are maybe not performing up to the rest of the others that are in the bigger group of people. So let's say you have ten companies in a sector, so you may have one or two that are the market leaders. You may have six to eight of them, five or six of them that are middle of the road performers. Maybe they're more legacy companies. They've been around for a while, and then you may have two or three other ones that are more laggards.

Dave [00:19:07]:

And they would definitely be probably legacy companies that have been around for a long time. Maybe their products are a little dated and they haven't really kind of kept up with the trends in that particular market. And so what can happen is if you look at those ranges of companies, there can be times where the leaders may come back to the pack because the other people may develop new technologies or new versions of their products, which allows them to grow, and the other people lose market share and they kind of revert back to the middle. And the laggards, likewise, could do the same thing. They could develop new products. Maybe they get a new CEO that re energizes the company and they come up with the greatest thing in that sector that allows them to ascend to the pack or even become the leader of the company. And kind of while all that's going on, you can have a reversion or regression to the average with everybody else that's kind of in the middle of the pack of the companies. And so that's why when you're looking at the market cap or the market share of different companies, it's good to kind of keep in mind how innovative is this company that's the leader, or who is considered the leader, and what other people might be ones that could unseat them and take some of their market share.

Dave [00:20:27]:

It's not that this company is performing poorly. It just may be others are performing better, and so they rise up to the level of the leaders, and the leaders maybe fall off the pack. So that's kind of how I try to envision it. What are your thoughts on that?

Andrew [00:20:42]:

Yeah, I love that idea. And I think especially in technology, you just see weird things happen. I mean, technological innovation and advancement doesn't happen in a perfectly straight line. And so sometimes being at a losing company can really unlock creativity. Nothing like having your feet to the fire to force you to save the company, and that could be the next thing know takes over your industry. I was watching a YouTube video, and I wish I remember who did it. It was a really good video. But he talks about the rubber band effect in the NBA, where it's like when a team is losing in the NBA, even the sports betters know that that underdog has an advantage because the team inevitably comes back.

Andrew [00:21:29]:

They might not come back and win, but generally the further behind they are in the game, the closer they'll get to the spread. And so there's that interesting phenomenon. There's something about losing that can sometimes motivate. And so, particularly in technology, I think you see a lot of that potential for reversion to the mean.

Dave [00:21:51]:

Yeah, exactly. I think a really good industry to kind of illustrate this point is looking at the semiconductor space. And if you look at a company like intel, intel at one point was unquestionably the leader of the semiconductor space. And then they started to kind of come back to the pack. They reverted to the mean and became more one of the, I guess, average ish companies. And now they're on the struggle bus. And so they're one of the laggards in the industry. Nvidia for a long time was more in the middle of the pack, and now they're the king.

Dave [00:22:25]:

And AMD has had times at the top and times in the middle. And you can kind of go through the whole list of companies and see them kind of interchange places. If you go back 30, 40 years, you can see this kind of ebb and flow of different companies rising to the top. Sun Microsystems, that's probably a bad word to a lot of people. But you look at all these companies, you can kind of see the ebbs and flows, and I think it's a really easy way to kind of visualize how the kind of reversion to the mean can work among companies.

Andrew [00:22:56]:

One last example, kind of throw out there. It doesn't just need to happen in technology, too. Sometimes you get companies that lag so bad that there becomes this pressure from shareholders, and that's where you can see big things change. You might see an activist investor come in and really shake things up, and sometimes that's why the company needs to rejuvenate things, try new things, go in a different direction.

Dave [00:23:23]:

Yeah. All right. Okay. We've talked a lot about sales growth. Let's talk about kind of the next chapter, and that's earnings growth. So why is earnings growth important, and how does that kind of relate to base cases?

Andrew [00:23:39]:

Yeah, earnings growth. If sales growth drives earnings growth, earnings growth drives the returns of a stock. In the short term, the price you pay kind of matters more with that. But over the very long term, if a company is growing at 15% a year for 20 years, their stock will probably grow by at least 15% a year over 20 years. That's just kind of the way it goes. So that's the reason for net income earnings being very important. And when it comes to stocks, it's earnings per share that matters most, not just earnings, because companies can play with the shares. The EPs is what matters if you're buying a share stock.

Dave [00:24:19]:

Yeah, exactly. And to me, one of the reasons why earnings are so important is because they feed into the free cash flow of the company. They're really the base of free cash flow. And if you look at financial statements, at the bottom of the income statement is net income or earnings. And if you look at the top of the cash flow statement, the first line item is earnings or net income. And so you literally take that number and plug it right into the cash flow statement. And that starts the process of determining cash flow for the business. And cash flow is the king.

Dave [00:24:57]:

It's what drives every single business. It's the lifeblood of every company. And earnings is the feeder for that, if you will. It's the Michael are the magic Johnson of financial statements, if you will. It's what feeds Kobe and Michael the free cash flow.

Andrew [00:25:15]:

Nice. So, I mean, did you see anything that stood out as far as the base rates for net income?

Dave [00:25:22]:

Not anything that really jumped out to me, per se. It's more the idea of understanding. Kind of similar to me, I related to the revenue or the sales growth. You have to look at the expectations, you have to look at what has happened in the past, the size of the company, and kind of extrapolate. What do you think is normal, depending on where they sit, a, in their lifecycle, and B, kind of how they sit in the industry as far as whether they're a market leader or whether they're one of the air, quote, normal companies. And that can really have a big bearing on where I think logically, when I'm trying to model or estimate the value of a company, it's going to come back to the base rate and what I think is kind of normal. What about you?

Andrew [00:26:06]:

Yeah, I didn't see much differences between the net income and the revenue. I probably didn't look hard enough. You see a similar trend with a lot of it. The smaller companies tend to grow a little bit more but also have a wider range of outcomes.

Dave [00:26:23]:

Right? Yeah. I think that's important for people to understand, too, is that the longer and older the company is, generally the narrower the ranges of expectations are. And so that can be comforting, but it can also be depressing. But it can also be hopeful because that's what the market can get. So juiced about a CEO coming in, a new CEO coming in is because the hope and the expectation is that maybe this person can revitalize this company. I think Disney maybe showcases some of that a little bit because they had a new CEO, Bob Chapick. He did some good things, maybe not some so great things. There was a lot of expectations of the company.

Dave [00:27:05]:

It's been around for a long time, and they let him go, and then they brought back going to blank on his name.

Andrew [00:27:12]:

Now Iger.

Dave [00:27:13]:

Thank you, Bob Iger. And the expectations are elevated now for Bob Iger. And there's some activism involved in Disney, and there's a lot of turmoil. But if you look at the history of the company, you would say that the ranges of expectations would be narrower because Disney's been around for 100 years, so your expectation would be different for them than it would be for Amazon. But with Bob Iger and the activists involved, you may have a higher expectation for the company based on those. And so maybe your ranges of outcomes could be a little bit more expanded than they were previously.

Andrew [00:27:49]:

Yeah. And kind of brings up something I did want to say at some point. So how do you kind of look at valuation with some of these base rates? Because if I'm a new investor and I hear, okay, your ODs aren't great, I might not think that high or long term returns are cards, but valuation plays a role, too. So how does that play a role in some of these base rates?

Dave [00:28:15]:

Well, I guess the way that I try to look at it is I use them as a launching point for determining what I think is reasonable. Let's just talk about revenue growth for a minute. I try to use the base rates as a guideline to give me a potential range of possible outcomes for sales growth. So, for example, if I'm looking at a company like Visa, very large company, been around for a long time, they're growing revenues at 11% to 15% over the last year or two. And if I looked at the base rates, I would say that the ranges probably give me an 8% to 10% range, and then it would be up to me to decide, okay, is that reasonable? Is that underperforming for them, or is that performing how I expect them to? Or is that overperforming? And then kind of trying to figure out maybe the ODs of those 30% of this 40% of that 30% of this kind of thing to see how logical they could be, and then trying to use plugging those numbers into my DCF models and seeing what kind of output I get from that and trying to determine whether I think that's realistic or not. And this is where some of the art of investing can come into. Because, yeah, we all want to love for visa to grow at 22% every year. I mean, who wouldn't? But is that realistic? Probably not for me.

Dave [00:29:46]:

It helps me build what I would consider more realistic models. It also helps me build in an idea of margin of safety. Because if you're going with a more conservative number and then the company overperforms, then the market's going to bid the company up. They're going to, hey, Visa is rolling at 14% revenue growth. That's awesome. And this is more valuable now than it was. And if I'm buying it at a cheaper price and now the market's saying, hey, it's worth more, that means that my shares are going to grow in value. I try to use it as, I guess, kind of like bumpers in bowling.

Dave [00:30:23]:

I try to use it as like bumpers to help me go, okay, if I stay in this range, I have a better chance of getting a good return because I'm maybe not underestimating, but kind of underestimating what I think the company is doing. I'm not automatically taking the bullish expectation. I'm taking more, maybe more middle of the road, or maybe even more closer to a bearish outview outlook. And if the company does better than that, then heads, I win, tails, I don't lose that much kind of thing. That's how I try to look at it. What about you?

Andrew [00:30:55]:

In the exact same way? That's a perfect way to think about it. And really, if you want to get good returns sustainably over the long term, and you want it to be more based on your skill level, not so much on random luck, that's probably your best option. So just think about this for a minute. I mean, probably don't want a stock that only grows at one, two, three, 4%, but let's say the market is expecting this stock to grow in that range, zero to five, but then the stock actually doubles what it was expected at, and it grows at five to ten. So if you have a stock that goes into that category, not only do you get the, let's say, 10% growth, but you get a doubling of your stock price because now the market is adjusting its expectations. And so that's really where the beauty of value investing can be. It's not an easy game, but if you can find, if I buy five or ten companies that are all expected to only grow low single digits, maybe one of those ten can outperform those expectations. And then if that stock doubles, you can have a pretty nice return in a short time period.

Andrew [00:32:08]:

So it depends on what game you're trying to play. It depends on how you're trying to navigate the market. And there will be times where that's a great strategy and times where that's a terrible strategy, but that's kind of where you can still get magical returns, even with stocks that don't grow that high. So to me, I don't get too negative on the fact that the ODs are, a stock will only grow revenues zero to 5% because there's also market expectations. And as those change, your returns can change, too.

Dave [00:32:36]:

Yeah, exactly. I try to look at these base rates as like, these are the guidelines. And then depending on what you learn about a company, some companies are just better than others, and they will grow faster for a longer period of time because they have a better product, a better service, a better whatever that people want and are willing to pay for for a much longer period of time than other companies that maybe are doing the same thing or similar things, but in a narrower range. Maybe they've been around longer. They haven't innovated their products for a while, whatever it may be. But the higher quality company will grow at a faster rate. And so you can assign it a higher growth rate just based on that research and that knowledge. And the market hopefully will recognize that over a period of time.

Dave [00:33:22]:

Sometimes it does. Most of the time it does. Doesn't always. So that's one of the fun parts of the market. There's no guarantees. There's no free lunch. Like Andrew likes to say, some businesses.

Andrew [00:33:33]:

Are simply otani, right?

Dave [00:33:34]:

Yeah, exactly.

Andrew [00:33:35]:

There's not very many Otani.

Dave [00:33:37]:

No, there really is. No, there really is not. I saw the other day that Jackie Robinson, Ernie Banks, and Nolan Ryan all celebrate the same birthday. Three of the greatest players in the history of baseball of all time, all celebrate the same birthday.

Andrew [00:33:53]:

So if you're trying to raise a child, keep that date in mind. You can somehow plan. Right, your master plan.

Dave [00:34:01]:

You're right. All right, so why don't we touch on the last one, which we wanted to cover real quick is cash flow return on investment. So a, what is this? And B, why is it important?

Andrew [00:34:13]:

Well, anything that tries to look at the ROI of an investment is going to be important. I like to look at Roic personally, but CFRoi. Mopeson makes a great, more precise metric that we can use to evaluate basically how efficient a company is, how they can take reinvestments into their business and generate growth. And so I use a simpler metric, I would say, than CFROI, but the intent is the same, which is to find a stock that has a business that has the ability to be efficient with its reinvestments.

Dave [00:34:53]:

And why is that important?

Andrew [00:34:56]:

It's important because the more efficient a company is, the faster they can grow, the less capital that they have to put into growing the business, the more that can come back to shareholders. So that means more dividends, more buybacks, more returns for the shareholders, even if the growth ceiling is limited. If they have a high CFROI or ROIC, then you can get extra returns that come not just from the growth of the business, but from all this extra cash flow that they have. Like visa is another great example of that.

Dave [00:35:29]:

Yeah, exactly. We've talked about regression or reversion with sales and earnings. How would that apply with something like a return on investment or a CFROI?

Andrew [00:35:40]:

All right, so here's where I lose everybody and I start to speak my love language, which if you can't understand it, I completely understand. Basically, Mobison looked at the correlation coefficients of CFROI and broke it into ten sectors. What he's trying to look at is, okay, if a business has a high CFROI, what are the chances that it's going to have a high CFROI again in a year? So what's the correlation? How sustainable is a high CFROI? And so what was interesting here, and this is just from one year to one year, we're not even talking about a long time frame, which we can talk about. You go from the highest correlation coefficient, which is consumer staples, all the way down to energy, which is the very lowest. And the difference is pretty stark. And so what that means is if I'm buying a consumer staple like Coca Cola and they have a 35 CFROI, just to throw a number out there, the chances of them, they will probably sustain that CFROI because consumer staples tend to be pretty stable. And so that means the verversion to the mean we were talking about for businesses is probably less in consumer staples than something like energy, which is on the complete opposite side of that. So you have energy and materials and then financials and tech.

Andrew [00:37:09]:

So in that case, chevron might have a gangbusters year, but that doesn't really say much about what they're going to do next year because the correlation coefficient is lower. Anything I missed on that?

Dave [00:37:22]:

No, no, that all makes complete sense.

Andrew [00:37:25]:

So what I found really interesting, he did it for a four year time period. And so the number goes from negative one to one. But basically, if you have a one that's as strong as you can be, zero means no correlation. And so energy over a four year time period had a very weak correlation, whereas consumer staples kept that strong correlation. So zero point 78 versus a zero point 33. And that's really eye opening to me that it makes you look at somebody like Terry Smith. It just clicks, right? Because he looks at return on equity basically. And then he also looks at low Vol stocks, which would be like consumer staples.

Andrew [00:38:07]:

And so he knows what he's doing because he's in that playground where the stocks that have high Roes will probably continue to do so. And to take Terry Smith's strategy and try to apply it to the energy sector, it's probably not going to be as good of a strategy because those returns on investment are so volatile.

Dave [00:38:32]:

Yes, exactly. So if we take the three kind of categories that we talked about, how can investors kind of take this idea of base rates and put it into their toolkit of investing? What can they take away from our conversation today that can help them tomorrow when they're trying to find companies or assess the companies that are already in their portfolio?

Andrew [00:39:00]:

I think they should go read the paper because I think everybody will get a different nugget out of it because we're all playing different games. I think so. I think if you're a growth person who's really looking for that bonanza outcome, then understand that the odds confine success. But you got to be careful. Don't put all your money into one basket, one basket and think that's going to grow at 50% a year.

Dave [00:39:26]:

Right?

Andrew [00:39:27]:

On the flip side, if you're looking for value, I would be careful. If you're waiting for a consumer staple to revert to the mean, that might not be a great strategy. So you could look at sales growth numbers, you could look at the correlation coefficient numbers. There's so much in there, I think everybody can take a piece from that. What about you? What do you think?

Dave [00:39:50]:

I agree with everything you were saying. I think the way that I would try to approach it would be maybe instead of reading the whole book would be to focus on one section of it, whether it's the sales growth, whether it's a couple that we didn't talk about gross profitability or operating leverage, and just focusing on those particular sections and looking at your companies or companies you're interested in and seeing how this can kind of apply to those and how you can incorporate these ideas into what you're already doing and kind of build on it as a foundation. Because I think, like you said, there's a lot of information in here, and if you try to read it like a book, you're going to get lost. But I think if you take it piece by piece, I think it can make it more digestible for people and more actionable. And sales is the most important thing. It's the first thing he talks about. And so I think if you really focus on that and nothing else, you'll get a ton from this. And it can really help help set up not only your valuations, but your assessment of the quality of the business and what kinds of returns you can hope to expect from a different company.

Andrew [00:40:58]:

Yeah. Great.

Dave [00:41:01]:

All right. Well, with that, I will go ahead and wrap us up. 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.

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