IFB344: Understanding Business Cycles and Fundamentals

Dave [00:00:00]:

All right folks, welcome to Investing for Beginners podcast. Today we have episode 344. Today we're going to answer some awesome listener questions we got recently. If you have a burning question you want to ask us, please send it to at newsletter at I investing for Beginners.com dot. You could also send us questions at Twitter or X at IFB Underscore podcast. Or you could also put them out there on social media Spotify as well. So with that, let's go ahead and dive into these fantastic questions. So here we go.

Dave [00:00:32]:

Dear Investing for Beginners podcast, thank you for putting out a great show for folks just getting started. Your content is just the non intimidating information needed. I'm planning on funding a brokerage account. I like the fidelity platform with an initial investment of $5,000 with subsequent monthly automatic deposits of $200 to $300. Taking Benjamin Graham advice to of not unnecessarily interrupting your compounding seriously. My question is about these subsequent deposits. Do I have to buy more shares of something already in my portfolio? Do I have to buy something new? Does it have to be the exact amount of the monthly deposit as a beginning investor in this for the long term? Is there a air quote set it and forget it model to use in the beginning as I build up both confidence and knowledge? Looking forward to hearing your thoughts and thanks again for such a great show. And this is from Ian.

Dave [00:01:25]:

So awesome question Ian and Andrew, do you want to go ahead and start us off helping Ian out? Yeah.

Andrew [00:01:31]:

Thanks for writing in Ian. I am jazz that you are getting started on this path. You've got a good grip and understanding on what you're doing and very thoughtful and how you're wanting to invest your money. So I commend you for that. To me the easiest set and forget it. If I was starting brand new and felt overwhelmed by the stock market and all the options is just buy an index ETF every month and then if you have a month where you feel like you have a better opportunity then buy something else at that time. But just have this backup plan that im going to buy. Pick one like spy.

Andrew [00:02:12]:

Id love recommending that its S and P 500 index ETF. Just buy that right? Thats the set and forget it. And I dont know if its fidelity or who the broker is but ive heard from people that you can. I believe I know you can do it with Coinbase but we're not going to go there. That you can set an automatic transfer and it actually automatically will buy the shares that you want so you don't even have to log in to your account to make the purchase yourself. Do you know who that is?

Dave [00:02:45]:

My guess is it's Fidelity. I know that you can do automatic transfers to Fidelity from your bank account because I do that myself. But I do believe, I think our business partner Evan mentioned that you could do that through Fidelity, that you could set up an automatic investment for you, especially in one of their funds.

Andrew [00:03:02]:

Right. So, I mean, that's the easiest set. And forget it. Icing on the cake when you find, if you find that you enjoy picking stocks or you find good opportunities out there.

Dave [00:03:12]:

Mm hmm. Yeah. It's a great way to set a base, right? To start setting the habit of investing, putting the money aside, having something bought, have skin in a game in the market that keeps you interested and learning about it. And it's also generally safer because you're not having to worry about the stress of buying Nvidia over Amazon and everything that's involved with that so that you can take your time to start learning. And if picking individual stocks is the way you want to go, then you already have a nice nest egg already built up as well.

Andrew [00:03:41]:

Yeah, for sure.

Dave [00:03:42]:

Yeah. So I guess maybe asking some of his other questions, answering some of the other questions, does he have to buy more shares of something he already owns?

Andrew [00:03:50]:

I mean, that's an easy way to do it, too, right. But then you could get into the tricky situation of your overpaying for some of those, depending on what you have. So I would caution against that. But I mean, there's all sorts of levels of commitment to how much time you're putting into the stock picking process. So maybe you're not completely in the set it and forget it stage. Maybe you're also not like spending all day long like Dave and I are looking at stocks. Maybe youre somewhere in the middle. And adding shares of companies that you are comfortable with already is a pretty decent way to go a lot of the time.

Dave [00:04:31]:

Yep, it is kind of. To answer one of his questions about do you have to pay the exact amount of the monthly deposit? The answer is no. And the beauty of fidelity, for example, is it allows you to buy partial shares of companies. And so if youre investing in shares in Mercado Libre, which is trading at 15, $50 a share, if you put $200 in your account, you don't have to wait seven months or eight months to be able to save up enough to buy one share. You can buy one 8th of Mercado Libre if you want to, for the $200 that you deposit. And likewise with the index funds as well. So if they're not, if they're trading for, like, I was actually just looking at Fidelity's 500 index fund and it's trading at $181 a share. So if you deposit $200, you can buy a little more than one share every month.

Dave [00:05:22]:

Or if you want to, if you put $200 in and you want to save $10 in the account for whatever reason, you can do that. You can always spend 190 if you want. So, I mean, the world is your oyster when it comes to these things. There is a lot of optionality with that, and it gives you, not every brokerage is like this. So just kind of be forewarned that other people out there listening. If you're not using Fidelity, this is from experience using the platform. But other ones have other options, but they may not all have the same. So just kind of an FYI for that.

Andrew [00:05:52]:

What about this question? Do I have to buy something new?

Dave [00:05:56]:

You do not. You can reinvest in the companies you already own. You do not have to buy something new. Sometimes, depending on how your portfolio is set up, sometimes the best investments are something you already own. We talked about this on the last episode. But you need to, you need to be cognizant of where the value of the company is. So you're not just paying. Sometimes the price can get away from you.

Dave [00:06:19]:

You can buy a company at a particular price, and then the market discovers how wonderful you've already known the company is. And then everybody and their brother bids it up into the stratosphere, and then it's not a good investment. So that's something to just kind of be cognizant of. But if you're buying index funds and you, let's say you have a basket of four of them, just for giggles, you can buy one or two, or you can split up the $200 between all four of them if you want. So it just really kind of depends on how you want to do it. But no, you do not have to buy something new every single time, because imagine you're like Joe Greenblatt in 2015, 422 stocks. I was like, yeah, no, what about.

Andrew [00:06:58]:

The stock picker who's all in and trying to maximize, optimize a return? What would your advice be for that?

Dave [00:07:05]:

My advice for that would be good luck. But no, seriously, the best way to do it is to try to find things that are in your portfolio that have a good opportunity for you to buy more of it. So if it's a company that you know really well and let's say that it is fallen on maybe some hard times. The market is kind of unfavored it for whatever reason. Then there might be a really good opportunity to buy more shares of a fantastic company and a company like Berkshire Hathaway, for example. If it drops in price for really unknown reason, then that could be a great opportunity for you to get more of the company. If there's some fundamental reason why the company has fallen, then that's more of a falling knife and you might want to avoid that. But if you know the company well and you see that the prices drop just because it's, you know, June, then that could be the best time to buy more of it.

Andrew [00:08:01]:

How do you balance that between opportunities that could be elsewhere?

Dave [00:08:06]:

Yeah, that's a hard question, isn't it? The way that I guess I try to approach it is sometimes the thing you own maybe the better opportunity just because you know it better. Sometimes we view the grass is always greener on the other side, and sometimes the other opportunity may not always be the best. But that's why you got to keep your eyes open when you're looking for individual companies. In theory, you should know the ones you own the best, and then other ones out there, they may offer a better opportunity. And if that's the case, then you can take a swing at those as you do the work. But it needs to be done logically and calculatingly in that you need to understand what it is, the business. You're not just buying another company just because your uncle told you about it at a Christmas party. That's not a reason to buy a company.

Dave [00:08:54]:

But if you find a great investment opportunity in maybe a sector you didn't know that much about, then that that could be a fantastic opportunity. But you got to balance it with how many companies do you own? Is this really a better opportunity than something you already own? And what do you think the long term prospects of that one versus the other one? So you have to balance the opportunity cost of buying something new that you own versus something you don't know and adding that to the portfolio. At least that's the way I try to look at it. What about you?

Andrew [00:09:25]:

I try to do some sort of screen near the beginning of every month, because by the end of the month I'm buying something and recommending it. So I try to look at a large number of stocks in the beginning of the month and then narrow it down. I don't get that perfect every time. And sometimes you find something you get really excited about pretty early. But for the most part, trying to zoom out frequently so that you don't miss opportunities, I found that to be a pretty nice way to find ideas.

Dave [00:09:56]:

Do you have a particular way you like to try to screen or a particular tool that you prefer?

Andrew [00:10:01]:

Lately, I've been using the quick FS premium Excel plugin, and then picking any metric that I fancy and using a macro and spitting out a bunch of numbers and seeing what comes up. So the answer is no.

Dave [00:10:17]:

Okay, so, for us mere mortals, how would you recommend we do something like that?

Andrew [00:10:22]:

You know, simpler is probably better. The problem with any screen is you can miss stuff that falls through the cracks. So, like Dave said, I think really well, always keep your eyes open. You never know where your next idea can come from. But if you're trying to, like, have a process that you're going back to every month, something simple like price to earnings or price to free cash flow, and that helps you weed out a lot of the, uh, just super expensive stocks that your value investor you never look at anyway. Sometimes I like to screen on return on equity or return on invested capital, because then you can avoid some of the stocks that are not great compounders. And then one last idea is you can also screen on dividend yield. Im finding myself doing that less and less now.

Andrew [00:11:11]:

But when you dont screen for dividends, you get a lot of companies that are in the growth or diluting stage. And depending on if thats somewhere where you feel comfortable or not, it can just be time consuming to wade through those. So those would be my ideas.

Dave [00:11:28]:

Yeah, those are great choices. I think the only one that I would throw on there would be revenue growth.

Andrew [00:11:33]:

Oh, yeah, for sure.

Dave [00:11:35]:

I know our friend Braden Dennis. He won't look at a company if it's not generating at least 10% revenue growth a year.

Andrew [00:11:41]:

Wow.

Dave [00:11:42]:

Yeah. You know, that's his drop dead point. If it doesn't meet that one criteria, he doesn't even bother looking. But, you know everybody, each to his own. All right, so let's move on to the next question. So we got a new listener. I am considering my next step. 457 retirement with $8,000 no employer match, zero debts, about 200k in cash, currently in a 5.4% CoD, or certified deposit income near 200k.

Dave [00:12:10]:

I'm considering beginning a retirement with fidelity further investments. Any ideas on index funds to begin with? M one finance, fidelity, or Vanguard. So, the two tickers he listed are FSkax and FX Aix. So these are two of the ones that they listed. So I guess what are your thoughts on this interesting question.

Andrew [00:12:31]:

I'll keep it short and sweet. You're asking the wrong dude. I don't optimize for ETF's, so I'm not ETF expert. I feel like if you're really trying to optimize for that, you can go for it. And the Internet has lots of answers on that. What's your thoughts?

Dave [00:12:46]:

I'm not an ETF guru or an expert by any stretch. I did look up both of these funds and they both look intriguing. They're fidelity funds. So the FSkax fund is their S and P 500 fund. And the one thing that I noticed about both of them is they have extremely low fees. So the expense ratio for the 500 fund is 0.15%, which is outstanding. And the other one is exactly the same. That's a total market index fund.

Dave [00:13:15]:

And I think those would be great choices simply for the fact that they're going to get you the same kinds of returns you would get for some of the vanguard funds with equally as low expense ratios. And I think probably the most important thing when you're thinking about index funds is the expense ratio, because the less that you pay is, the more that you get to keep in your pocket. In this day and age, theres really not a whole lot of reason when youre paying for index funds or mutual funds to pay a high expense ratio, because the majority of it is managed via computer. And so there isnt a lot of human interaction with a lot of this. And so why pay 2% for an index fund that you can easily get from Vanguard or fidelity for cents of pennies on a dollar? So that would make a lot of sense really, when youre thinking about ETF's ill throw one thing out there. When I was working in the bank, the financial advisor that I work with kind of gave me a guideline, if you will, to set up an ETF portfolio. And so I'll just kind of throw out percentages. And this is not investment advice.

Dave [00:14:17]:

And if this is something you're serious about, please talk to an advisor before you just take something that Dave said on the air as gospel. So, but this is kind of how you recommended I set up my 401K, for example. So he recommended 40% in a S and P 500 fund, and then he recommended 20% in a mid cap fund. So those are smaller companies but not small companies. And then he wanted 20% in an emerging market fund. So those were investments that were outside the United States, in places like Brazil or India, things of that nature. And then he also recommended 10% in a international fund. So those were more larger, well established foreign companies.

Dave [00:15:03]:

And then the rest of it he recommended in a bond fund. So it was like ten or 15%, whatever the percentages are, he recommended as a bond fund. And so he said that the way he put it was it gives you a lot of exposure to the best companies in the United States. It gives you a small percentage of opportunities outside of the United States, and it gives you a little bit of security with the bond funds. As somebody that was a little older in the game and still wanted to be aggressive, he felt like that was a really good way to try to air, quote, optimize my portfolio and also give me a little bit of security. Target date funds do a similar thing, but im not as big a fan of those just because you dont have much control. And so with this setup that he suggested for my 401K, it allowed me to have the opportunity to have some discretion on how I wanted my money invested. So that could be a way, if you want to optimize your portfolio, is you could look at percentages like that.

Dave [00:15:56]:

There's a woman that I follow on twitter. Her name is Lynn Alden, and she is very much an economics guru, but she's also a big ETF investor and she talks a lot about like portfolio construction and things like that for ETF's. So she would be somebody that would be good for you to check out.

Andrew [00:16:11]:

Perfect. Yeah, I love that.

Dave [00:16:13]:

All right, so let's move on to the last question. So is there any research on which fundamentals are most important on a sector by sector basis? For example, price to book or pb seems to be like it is more important for a financial stock than a tech stock. Was curious if there is a list on which fundamentals are more important to look at for particular sectors. So fantastic question, Andrew, do you want to take a first swing at this?

Andrew [00:16:40]:

Yeah, I wish there was a list. Right. Really the only, by my knowledge, kind of the way I try to look at it, the only universal metric, if you will, would be like a DCF, which Dave, youve taught that very well in your course that you offer. But as far as financial is a good example, the price to book tends to be more prevalent there.

And then in tech, you dont get those companies are very asset light, so they dont have a lot of assets. And so thats why their price to books a lot different with every sector. Theres a good reason for why a metric might be more favored than another, but theres no hard and fast rules as far as which sector should use this and which sector should do that, I think some of its intuitive and then some of its just wisdom of the crowd. I mean, what stands out to you about that?

Dave [00:17:32]:

Well, if you think about probably, if we just stick to ratios, for example, price to earnings, price to sales, price to book, price to free cash flow, seem to be probably the more prevalent ones, at least the ones that are price related and are closer related to either the income statement or the cash flow statement, depending on which part of fundamental analysis. So if you're looking at the balance sheet, for example, the metrics for those are going to be different than the ones that you're going to use for the income statement or the cash flow statement. And so it really depends. But if you look at those four that I mentioned earlier, those seem to be the most common bandied about amongst other investors, and it really depends on what you're trying to say and maybe even somewhat where the company is in their life cycle, for example. So if you got a brand new company like Reddit, for example, just IPO'd, and you cannot compare the fundamentals of Reddit to the fundamentals of Google, even though they're somewhat in the same industry, and Google is actually paying Reddit for some stuff, they're not at the same. Reddit is still like a three year old and Google's more like a 27 year old, so they're not at the same place. You can't use a price to earnings, for example, to really compare a company like Google and Reddit, you may be able to use a price to sales, but that could be iffy too. So it really comes down to you have to understand where the company is in their life cycle, and then you also have to understand what sector they're in, because there are sectors that are very different than other sectors.

Dave [00:19:11]:

Reits, for example, real estate investment trusts, the language that you learn to speak to understand those is vastly different than it would be for Reddit. For example, price to funds from operations, for example, or depreciation is a very big thing in real estate, but it's not such a big thing in Reddit. It's just not the same. Apples to apples. And so to Andrew's point, some of it is intuitive. The more you study a different sector, the more you're going to pick up on the different kinds of metrics and fundamentals you need to know about those particular industries. The financial industry is a different beast. The insurance industry is a different beast.

Dave [00:19:52]:

Combined ratio insurance, float premiums, earned premiums unearned premiums, all those terms, those are all things you need to understand and know to be able to value a company like a progressive. You can't use the same price to earnings, to value progressive, to value Crown Castle, or to value Reddit. So it's not apples to apples. Some of it's going to be intuitive. The more you study different sectors, the more you're going to discover the language that they speak for those particular sectors. And then other sectors are going to be the language you use for payments versus the language you use for tech. It's going to be the same, but that's kind of how I try to look at it. What are your thoughts on any of that?

Andrew [00:20:31]:

Yeah, you know, that's actually a very easy explanation for why I don't buy super young growth companies.

Dave [00:20:39]:

Right.

Andrew [00:20:40]:

It's not the same game that you're playing if you're trying to buy something that's more matured and generating cash flow instead of consuming cash flow.

Dave [00:20:50]:

Yeah.

Andrew [00:20:50]:

That simple, right?

Dave [00:20:51]:

It's really that simple. And when you look at those companies, if you want to invest in those, you have to understand that it is a lot more speculative. You're really more betting on them growing into their value, if you will, as opposed to being more established. If you buy Google far more established than a company like Reddit is. I'm not saying that one or the other is going to be a better investment, but the mindset to invest in Reddit, it has to be different than the mindset to invest in GooGLE because the expectation is completely different.

Andrew [00:21:25]:

Yeah. Swinging for the fences versus making hard contact.

Dave [00:21:30]:

Yep. Yep, exactly.

Andrew [00:21:32]:

One other thing too that I didn't understand early enough in my investing journey was how much growth plays a role. So now kind of moving on to the, the companies that you can use fundamentals for that are generating cash flow, that pe really can change depending on how much a company has been growing and is expected to grow into the future. That pe, I think sometimes we see sectors that get higher pes and sometimes there's a good reason for it. And other times I think it's just because they're just faster growing industries and that could be all it comes down to.

Dave [00:22:14]:

Robert, can you maybe dig a little deeper into that? Maybe explain why some of those companies, maybe their pes are bigger than others?

Andrew [00:22:21]:

Yeah, I feel like I use this example a lot, but going back to the banking industry, outside of using acquisitions or being very aggressive with your lending or the way you're generating deposits, its hard for them to grow as fast as a newer industry where theres a bunch of market share that people can grab. And so for banking, the pes have been low for over a decade, if not longer, to reflect this reality. And so if you have an industry that has a higher p e than banking, it probably has a higher growth expectation. But thats not always the case. Thats kind of how I try to look at it.

Dave [00:23:06]:

Yeah, I mean, I think that's the perfect way to look at it, is you have to understand the fundamentals of the industry and also where it kind of sits in the industry and what the market sentiment is about those, because a lot of that will drive the expectations, will drive what people expect from different companies that investors. The market's reaction or expectation for Wells Fargo is far different than it is for Nvidia. And so to assign or to compare those two companies is not a great idea. And number two, the expectation is vastly different for both. And so when you're looking at the different fundamentals or the ratios of those companies, you just have to treat them differently.

Andrew [00:23:50]:

Yeah, it's just so interesting.

Dave [00:23:52]:

Right.

Andrew [00:23:52]:

I think that's another thing that's not intuitive for beginners, but you learn that lesson eventually is just because a stock is a good business doesnt make it a good investment. Because if everybody already knows its a good business, then theyve already priced in all the future growth. So the return you actually make also depends on what price you pay. One other one that stood out to me, I think you could apply this to probably a decent amount of commodity sector, commodity industry businesses. But for me in particular, I have an investment in a plastics company. And so I looked at the history and I noticed a trend with the price to book ratio. And when the price to book is lower than where it usually is, its generally a decent time to buy it. And so ive done that with a company in my portfolio.

Andrew [00:24:47]:

And that can be a good way to go because it can help you buy when people are pessimistic about the industry and a lot of cyclical industries will revert to the mean. The reason behind that being that these are very boom and bus industries. And so you cant use a price to earnings ratio on a boom and bust industry because whether theyre in a boom or a bus, its affecting their profitability versus like a proctor and gamble or something, whos selling these soaps and, and you know, laundry detergent year after year after year, not very boom and bust. So with the commodities, you're basically, if you're buying on a low relative price to book can be one way to do it. You're basically betting that there is pessimism in that industry at the moment, and you're also betting that there will be a reversion to them, to the meat. So where you can get burned there is. If the pessimism in the industry is because of a secular decline reason rather than a temporary thing, that's kind of, I guess, where the sweet spot in those industries are. If you can decipher whether the pessimism is because it's a natural cycle or because actually this industry is slowly being disrupted, that could be a hard thing to do, especially when, I mean, you talk about, I don't know, some of the electric vehicle stuff and how that's changing a lot of different industries.

Andrew [00:26:12]:

There's disruption. But then you ask yourself at what scale is it happening? So it's not always cut and dry. But in general, I think that could be one way to look at boom and bus industries is look at historical pb.

Dave [00:26:25]:

So that's a great insight. And to your point, I've read some about Autozone and O'Reilly, and that's one of the concerns in the industry is how is this trend towards electric vehicles going to impact their business model? Because, you know, they sell parts for, you know, cars and you know, the electric cars don't need the parts, so, or limited amount of the parts. So how is that going to impact an autozone or O'Reilly? And those are things you got to keep in mind.

Andrew [00:26:57]:

I saw a video from Monish. I think that it was very recently uploaded as he always is. He's talking to like a group of students, right, like a class. And he mentioned that the narrative is that you wont need part or you wont need to take your car to a dealer when you have an electric vehicle. He was arguing that actually the price of the battery of replacing it might make the dealerships still an attractive thing to invest in because he thinks that narratives overblown. Again, very interesting. I think you can have a lot of ups and downs with making those kinds of bets whether something's going to when the price earnings are so low there.

Dave [00:27:40]:

Yeah, yeah, exactly. I think bottom line, when you're thinking about trying to do research on any particular company or sectors, you have to learn what's important for that particular sector and then kind of stick to that and try not to cross the wires, so to speak. And I think we've given some examples of things not to compare to. But once you get your hand around a particular industry, then I think it's a lot easier to understand, but I'm not aware of any sort of resource out there that can tell you, okay, if you're studying these kinds of companies, look at this and these kinds of.

Andrew [00:28:15]:

Companies, look at this.

Dave [00:28:17]:

It's more intuitive. Like Andrew was saying early on.

Andrew [00:28:20]:

Yeah. What would be a good way for somebody to learn that for themselves? Say they're. They're wanting to tackle some industrial industry.

Dave [00:28:29]:

Well, the most obvious place to go would be to read the ten k or the financials of the company, because they will outline the things that management in particular, will outline the things that are important to them to manage their business. And so you can take note of those things. The other place I would look would be earnings calls, because the analysts that are asking management questions are going to focus on things that are important to them, to both management and to the analysts. And so that can give you some insight into. Oh, okay. So this particular ratio is super. Or these particular facts are really important in this particular industry, and then you can apply those to other companies in the same industry. That's how I would do it.

Dave [00:29:08]:

What about you?

Andrew [00:29:09]:

Yeah, very similar. Try to look at multiple companies in the same industry, up and down the value chain. Suppliers, customers. Yeah.

Dave [00:29:19]:

Yep. Yep. That's the best way to do it. All right, well, with that, we will go ahead and wrap it up. Wanted to thank everybody for taking the time to send us such fantastic questions. Please keep them coming. If you do have any questions, send them to newsletter at I investing for beginners.com dot. I put the link in the show notes.

Dave [00:29:35]:

You can also send it to Twitter or X at IFB Underscore podcast. Or you can reach out to us on Spotify as well. So with that, I will go ahead and sign us off. 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.