Back to Basics: Avoiding Financial Statement Yellow Flags

Dave [00:00:00]:

All right, folks, welcome to Investing for Beginners podcast. Today we're going to do one of our back to the basic episodes. If you are new to the show, this is something that we do every Thursday. We have a group or a list of topics that we wanted to work through to help give everybody a good foundation as they start to invest. So today's topic is going to be yellow flag metrics. So, Andrew, do you maybe want to start and talk a little bit about what we mean by yellow flag metrics?

Andrew [00:00:28]:

Sure. So buying stocks is hard. Selling stocks is hard, probably even harder, because you're like breaking up with a good idea and then you're either accepting that you made a huge mistake and you feel dumb or you're feeling regret that, oh, man, this thing has done so well. What if it keeps doing well? You're going to be in those two camps every time you sell. So it's hard. But, you know, sometimes, you know, the red flags are easy. It's like, yeah, this is terrible. I'm going to sell.

Andrew [00:01:01]:

Somehow those are almost easier in the stomach as stock pickers than the yellow flags. So I don't have, like, the answer to you of whether this yellow flag means a seller that one doesn't. But hopefully, as you gain experience in identifying yellow flags, you can get ahead of the curve and not get wiped out by big surprises as much as somebody who maybe doesn't care about looking at any flags.

Dave [00:01:30]:

Yeah, exactly. Yellow flags, I have found, can often turn into red flags, and so they can be cursor to something deeper or more troubling down the road. They also could be opportunities for the company to present opportunities or occasions that they can turn around or change the direction in particular of a certain thing, whether it's, you know, a new product, a new CEO, changes in the operations of the business, you know, a Whitney of things. But sometimes there's just one offs and it's just something that, you know, a

previous management made a boo boo and the new management has to deal with and clean up the mess. Or sometimes they're more systemic or more deeply rooted in, in the yellow flags, if you will. But, yeah, they can. If you don't pay attention, they can turn into red flags. And that's when you can get in a lot of trouble.

Andrew [00:02:21]:

Yeah, very well said.

Dave [00:02:23]:

So let's talk about maybe we got like eight or nine of them we wanted to maybe chat about today. So the first one I wanted to throw out there is revenue growth slowing. So what does that mean to you?

Andrew [00:02:36]:

I guess there's different severities. What about for you?

Dave [00:02:41]:

Yeah, there's different. To me there's different severities. And I think the, I guess, define as revenue slowing is not looking at a quarterly report and seeing that this quarter was slower than last quarter. Thats not really what were talking about. Or even this year is slower than last year. Its not really about that. Its more about a longer term trend, 3510 year trend of gradually slowing or flat revenues. And those can be yellow flags.

Dave [00:03:15]:

It doesnt necessarily mean the company is going under or its bad. It just means that maybe your expectations in the future should not be the same as what happened in the past. We recently talked about a company three m who is going through some struggles. But if you look at their revenues, their revenues are, have been flat for the last five or six years. And it's not a death sign, but it's also not super encouraging. And so that would be something you would definitely want to watch. And so I guess that's kind of how I try to look at yellow flags. Do you have any other thoughts on yellow flags?

Andrew [00:03:49]:

Yeah, I have a few on yellow lines. Yeah, sure. Or we could sign out right now. One that, to sell something recently is declining ROIC. So return on invested capital should tell you how a business is doing and how efficient they are when they reinvest in their business. How much return are shareholders getting? And so in some cases, a declining ROIC is fine if they're getting a ton of growth. But if you don't feel like that growth is sustainable or they're not getting the growth and ROIC is declining, that can be a signal that we're,

management's really stretching to try to grab that growth wherever they can get it, and they're just not able to get it. And they're trying to spend more and more and more to try to get just a little bit of growth, and they're getting worse and worse and worse results.

Andrew [00:04:46]:

And so that can be one that's tricky that you have to interpret in the right way.

Dave [00:04:53]:

Yep, exactly. And the reason why that's important is when you think about management, their number one job is to allocate capital. And so every business hopefully makes money. And when that company makes money, they have choices of what to do with that money. And one of the more important choices is how to allocate that to reinvest in the business, to grow the business. And to Andrew's point, if the management does a poor job of that or they don't have a lot of great opportunities to grow then they can either choose to make bad choices, or they can throw money at a dividend or buy back shares or pay down debt. I mean, there's lots of different ways they can go, but depending on where that company is in their life cycle and how well they allocate that money goes a long ways towards what kinds of returns we get as investors. And this is Uber.

Dave [00:05:54]:

Uber critical to a good return is a manager that can allocate the money really well. Warren Buffett is not just a great stock picker. Hes also an amazing allocator of capital. And thats been one of his stalwart traits for 50, 60 years. And thats why he stood out, is because hes been able to take all the money that Berkshire Berkshire makes from their businesses and invest it really wisely into either other businesses, other investments, or the companies that they already own. And because of that, he's been able to earn 20% returns for shareholders in Berkshire hathaway because of that. And that's what you want. A lot of people were very negative on Jeff Bezos when he was in there because he's a bit controversial.

Dave [00:06:40]:

But you can't argue that he wasn't a fantastic allocator of capital. Elon Musk is also very controversial, but hes also been a really good allocator of capital, not only with Tesla, but with his other businesses. And so thats really, really important. And ROIC is one of those metrics that we can use to help us measure how effectively and efficiently, because its an efficiency ratio, and the higher the number, the better. It just means. So if a company is generating 40% ROIC, that means for every dollar they reinvest, they earn forty cents. And that may $0.40, big deal. But when you think about the billions that they're dealing with, that those are big boy numbers or big girl numbers.

Dave [00:07:21]:

And so that becomes real, real money, and that's where that number becomes super, super important to understand. Yes.

Andrew [00:07:31]:

Yep. Can be an early signal sometimes, for sure.

Dave [00:07:33]:

Right.

Andrew [00:07:34]:

Sometimes it's a trailing signal, but sometimes it can, it can predict, right?

Dave [00:07:39]:

Yep. Yeah. Another one I wanted to throw out, there was gross margins declining. And the reason for this is gross margins can tell you a lot of it can signal a lot of things about a company. Number one, if the gross margin is growing, that could be an indication of several things. Number one, pricing power. Number two, it could be an indication of potential moat or competitive advantage, because if they're able to raise prices and continue to grow the margins, then that means that they have something that people want over other people that maybe they're competing against. And if it allows them to continually raise the prices, sometimes bigger, sometimes smaller, but even if they're able to raise those prices and still create a demand, like the revenue keeps going up, but they raise the prices, that means that it just gives them more margin, which then they can use to reinvest in the company, like we were just talking a minute ago.

Dave [00:08:36]:

Likewise, if you see that those margins are on a slow decline or a gradual decline over many, many years, then that could indicate that theres something wrong with competitive advantage or they dont have any pricing power, and that can lead to poor investment over a longer period of time because they just cant generate enough revenue because they cant charge more for their stuff.

Andrew [00:08:58]:

Yeah, thats a great one. And a lot of times, well, I dont know if its a lot of times, but one of the ways that ROIC can decline is because gross margin is declining. So maybe management is actually doing a decent job at allocating capital, but the core business is losing its advantages, and so theyre getting that gross margin decline and its flowing through to the ROIC.

Dave [00:09:19]:

Right.

Andrew [00:09:20]:

Are there times where you look at a declining gross margin and youre like, im not too worried about this right now?

Dave [00:09:27]:

To me, it would be. There are a few, I guess maybe not times, but certainly different kinds of businesses, depending on how cyclical they could be. I dont invest in commodities, but if youre investing in a commodity and the price of oil is flying all over the place, then thats going to directly have an impact on Exxons margins. Or if youre looking at Albemarle that deals with lithium and the price of lithium fluctuates at all, thats going to obviously have a big impact on their margins. Itll depend on the cyclicality of the business. If the company is seeing a lot of demand and then that demand dries up, that could indicate some cyclicality to the business, too, I think like Texas instruments or somebody like that, where you kind of see these peaks and valleys in their revenue growth as well as their profitability. And some of that's just the nature of the beast. How about you? Yeah.

Andrew [00:10:26]:

Yeah. I think of it the same way. Also.

Dave [00:10:29]:

We got another yellow flag you want to throw out there.

Andrew [00:10:32]:

Sure. Whats another reason? I just sold a company. Those tend to bite the hardest, kind of going back to the capital allocation. When you see a huge outlay of capital and its suspicious or just, it doesnt add up. For example, if a company usually generates, I dont know, 800 million a year in free cash flow. And then they buy something for $8 billion in a year and they're making a huge acquisition and just loading up the balance

sheet with a ton of debt to make this acquisition. And Dave and I talked about this off air a little bit. To your point, if they don't have a track record of doing that successfully, that could be a yellow flag with red.

Andrew [00:11:22]:

Red tinting like around the edges. Yeah, exactly.

Dave [00:11:26]:

Depending on the severity. And that red could be.

Andrew [00:11:30]:

Yes. And then you could sell because of the yellow flag with red tinted, and then the stock continues to go up anyway because the market hates you. So that's a big one to me. I think for whatever reason, some of that can fly under the radar and it's like, no, those are huge bets that they're making.

Dave [00:11:48]:

Yes.

Andrew [00:11:49]:

And if they don't pay off over the long run, it's going to hurt so very much. Watch out for them. Yeah.

Dave [00:11:54]:

Yeah, very much so. Allocation, capital allocation, as I mentioned earlier, is critically important. And one of the big ways they get do it is pulling that m and a or mergers and acquisition lever. And the thing is, is that there is a definitive skill to that. And if the company does not have the resources, the culture and the systems set up to successfully merge or I guess meld all the different pieces together, then it's going to be an uphill battle to get the kinds of return you expect from that kind of investment. If youre plunking down 8 billion in future cash flows, youre going to expect a nice return on that as an investor. And if the company doesnt have that in their DNA, it can be tough. You can go on Google and you can google the top ten worst mergers and acquisitions.

Dave [00:12:52]:

And youre going to see quite a few very interesting choices by management in the past. And a lot of times there are companies that are called serial acquirers. Then basically how they grow is by buying lots of

businesses. And that's in their DNA and they do it very well. So it's very unusual to see something go south when they do this for a living, and that's part of their strategy and whatnot. But to Andrew's point, if there's a company like, I'll give you one that we were talking about off air at and t when they bought Time Warner, that to me was kind of bizarre because it was not really in their circle of competency to buy a media content strategy company. Like, I get that they were trying to become a competitor to Netflix. And I understand that, but that's not really at and t's jam.

Dave [00:13:43]:

And so it just didn't make a lot of sense. And they spent a lot of money and they lost a lot of money, and they sold it in, like, three or four years. And now Time Warner, Warner Brothers, whatever you want to call it now, it's bounced. It's been like a hot potato between all the other companies since then. But it was a bizarre choice of capital allocation, and the stock has done very, very poorly since then, not solely because of that, but I think that had a big part in it, and it would make me. To me, it was more of a red flag than a yellow flag. It was screaming red with a hint of yellow to it. Not that I was invested in at and t, but when you see those kinds of things, you have to ask why.

Dave [00:14:24]:

You know, sometimes it's just ego driven. Sometimes they're. Maybe they think that they can have synergies. That's one of their favorite terms, or they just don't know where else to put it and they decide that they want to do it. And the, the board of directors is just, you know, rubber stamping all the CEO's directives, and then it just happens and it's a poor, poor allocation.

Andrew [00:14:45]:

I'm going to. I'm going to. I'm going to ruin the punch here. What, what about, like, how do you determine if a risky acquisition is actually a good one? I'm thinking of, like, Google buying YouTube or Facebook buying Instagram, where everybody around you thinks you're crazy and turns out to be, like, super brilliant. Yeah.

Dave [00:15:11]:

Yeah. I can't speak to Zuckerberg, but Google had a track record prior to buying YouTube, of buying companies basically add ons, tuck ins, not like, major life changing direction in their business, but more like, this could be a great addition to what we already do, or they could help expedite. We want to get into video, and this company does it way better than us. We buy them, we integrate them with us, and we go on. So Google had a track record for it, so to me, that wouldn't have been quite so, I guess, exotic. The Instagram purchase, I think, was probably a little more out of the blue, and Zuckerberg probably didn't have as much of

a track record, so that could have been scary, I think. But obviously, that's turned out kind of good. So, you know, that gives, that gives them more, to me, that gives them more juice farther down the road.

Dave [00:16:08]:

You know, if they do make a suspected, a questionable choice of a company to acquire in the future.

Andrew [00:16:18]:

Yeah, I love that.

Dave [00:16:21]:

Yeah. I think it's a great thing to think about. Another one I want to throw out there is related to acquisitions is a goodwill write down. This is related to an acquisition in that part of Goodwill is part of the calculation of when a company buys another company, the air quote overpaying of the price gets put into goodwill, which goes on the balance sheet of a company. By GAAP accounting rules, the company has to value the business that they bought every single year. So part of that valuation is valuing the goodwill or the. The extra asset that the company has acquired and how much that overpayment is still valued at being worth. And if that ever changes, then the company has to put, let's say that they buy something and the goodwill is $5 million, and now they have to write off that $5 million.

Dave [00:17:23]:

That $5 million goes on the income statement. And so instead of having a nice, shiny, great quarter or year because they made all this money, now it's super negative because they basically had to sell the business, or they have to devalue what it's actually worth because they've done a poor job or the company hasn't executed, or million different reasons. But if you see a goodwill that's a line item that you will see on the income statement periodically when this happens to a company, and it's not necessarily a red flag, but it certainly could be a yellow flag. It could be just kind of a tag on to at and t making a poor choice and buying Time Warner, then having this huge goodwill write off that would, to me, was a red. It was just kind of a. Even more screaming red flag. It can be a yellow flag if it's a smaller amount or if it's a little more unusual.

Andrew [00:18:12]:

Yeah.

Dave [00:18:12]:

Any thoughts on that?

Andrew [00:18:13]:

I would try to picture it like, buying overpaying for a company is like management taking some dollar bills and lighting them on fire. And then the goodwill impairment is them realizing those dollar bills are no longer in the company's bank, but they're in ashes, and so that's the impairment, is them fixing the books.

Dave [00:18:36]:

Right.

Andrew [00:18:37]:

But the money was already. That's something that drives me nuts about when people talk about impairment, like, oh, well, it's a non cash expense. Yeah. But we're just. We're getting the forensics on what happened. It doesn't mean. Just because it's not gonna take cash from the future doesn't mean it didn't happen, you know?

Dave [00:18:52]:

Right.

Andrew [00:18:53]:

But it's totally a yellow or red flag.

Dave [00:18:55]:

It also reduces the value of the business, you know, the book value, the shareholders equity, you know, gets reduced because the assets reduced, then the equity, you know, gets reduced as well because the liabilities go up. So, you know, it just means that our money is worth less, you know? Yeah, we may not actually exchange cash for it, but it also means that the value of the business is less. And so it's, it's a very real cost to people that are investing in the company. I guess that would be my argument.

Andrew [00:19:28]:

Yeah, for sure. A yellow flag, that's, this could be tricky and you have to be careful how you analyze it. But if you see competitors starting to take off and your company's kind of sitting in the dust, so maybe they were on equal footing, or maybe it never was on equal footing, you just didn't realize it. But if you start to see competitors pulling away and you find yourself creating justifications for why that's the case, you could just

be putting your head in the sand and trying to ignore this yellow flag that's up there. So management's and investors who are, who have skin in the game can very easily convince themselves and others that things are all going smooth sailing. Sometimes the numbers will tell a different story and it's a really hard, that's a really hard reality to grip with. But if competitive, if they're not keeping up with the competition and it's happening over and over again, then sometimes you gotta call a spade a spade.

Dave [00:20:32]:

Yep. I know you can't like set a hard date on it, but like, are we talking a couple year period? You seeing like this over a five or ten year period? Or can it be more contracted than that?

Andrew [00:20:45]:

Yeah, I guess it probably a good answer would say like five or ten years. But you know, if a business is in a dynamic industry, especially the, the more tech you are, the faster things can, can change. And so you do have to be careful. And I don't know, I mean, it would take a lot of fortitude to sit around for seven years as things seem to be crumbling around you. So five to ten years sounds good on paper, but in reality, I haven't been able to wait that long. Like, if I sense things are starting to crumble, I tend to get out a little sooner.

Dave [00:21:22]:

Right? Yeah, I mean, I try to think of, I know I've talked about and I've written about the kind of the dead years, if you will, or the lost decade of investing in Microsoft. And I just think about, you know, how would I have mentally dealt with that? It's one thing to not a not be skin in the game at that point and being removed from that period and just analyzing it from a historical point of view, it's okay. You know, it's easy to say things, but if I was in year three of that ten year period, how, how would I mentally deal with that? You know, to your point, you know, could you grind, could I grind through the next seven years owning the company as it's flat?

Andrew [00:22:06]:

I don't know.

Dave [00:22:07]:

You know, it's like, that'd be hard. Be really hard.

Andrew [00:22:10]:

Very hard. Yeah.

Dave [00:22:12]:

Yeah.

Andrew [00:22:12]:

That's a great example, by the way. Make you think that some of these yellow flags should be taken with a grain of salt. Maybe not all of them, but the ones that are more subjective, the sense of like, maybe a good competitive moat won't always beat competitors. Every year, you know, out of ten years, they're not going to be the competition every year out of ten, right?

Dave [00:22:35]:

Yeah, I think that's probably, you know, depending on how, how close the competition is and whether. I think there's going to be a few things that could have a bearing on it. One would be if you're in a duopoly or triopoly, a triad. I think that could be a little different. Like, let's throw the cloud providers out there. Google, Microsoft, Amazon. Let's say Amazon wins two out of every three years, but Microsoft comes and wins one year and then they go back to being second again. I don't know that if I owned Amazon, for example, I don't know if I would get too excited about that because you kind of see the, you see the horses changing, who's leading every once in a while.

Dave [00:23:22]:

And that's, I think that's kind of understandable. So I think in that circumstance, I think I would probably, I would probably just, you know, I would take it with a grain of salt. I think if it was more along the lines of, let's say, Kroger and Walmart and Costco for groceries, and you see that Walmart's always ahead, but then all of a sudden Costco takes over and starts passing and consistently does better than Walmart. And I owned Walmart, then I would be concerned. That would be something that I would probably be like, okay, I was okay with them passing them last year, but they did it again this year and now they did it again this year. So now it's three years in a row. That could be, to me, that would be maybe a trend that is not great.

Andrew [00:24:07]:

Okay, here's one. What if the there's jockeying. And I'm asking this selfishly because I want to see, you know, when you throw companies into it, it's so easy. Leather biases. Oh, yeah. Change how we would answer it. I know. I do it all the time, especially when you start mentioning Costco.

Andrew [00:24:24]:

I got excited, obviously, by Costco. What if one company has been granularly under the other two for, let's say, like a decade, and then it ended up being a capital allocation failure? That CEO is now gone. How would you place that in this whole, like, yellow flag? Do you have them on the really tight leash? Is it a longer leash?

Dave [00:24:47]:

So basically what you're saying is the number three player had or CEO, and they got a new CEO, and you're wondering, how long would I give them to turn things around? Yeah, I think you have to give them. Got to give them a year or two to turn it around. Because I think the, you can't turn the Titanic the same way you can turn a speedboat. And it just takes a lot longer to turn things around because you think about, and I'm thinking about PayPal. So if I put that in perspective with PayPal, they have a core business that's really successful. They have a product that people really like, but they've also done some not so great capital allocation culture, direction missteps, and a new CEO has been in place for a couple quarters now. And I think the expectations are very low. But I also think that you got to give them time to change things.

Dave [00:25:53]:

Because if you've ever worked in any sort of bigger company, you understand that to change the mindset not only of the underlings, like the C suite managers, but all the people below them, it just takes time, you know, to get the right people in there to change the attitudes and the opinions and maybe how they do things, I think it just takes time. And I'll give you an example, maybe more concrete. If you go to a chick fil a and you experience what good customer service is like at a fast food restaurant like that, where the employees smile at you, they address you, they look at you, they thank you for your business, all those little things, and then you go to another fast food restaurant and you can pick any one you want, and they don't perform at that same level, and it's very noticeable. But then if you take the same general manager that's running a chick fil a and put them in that other restaurant, he's not going to make that a chick fil a. Culture like that, it's going to take them at least six months to a year to either clean out, get employees in there that are going to buy into what that person is preaching or just to set up the systems and change the things that need to be changed so that the customer service change can happen and it doesn't happen overnight. It's, you know, what, what does Buffett like to say? A good manager meets, you know, with a good reputation meets a company with a poor reputation. Usually the poor, the company with a poor reputation is what remains kind of thing. So I think, you know, it takes time for a CEO to take over.

Dave [00:27:32]:

I feel like it takes time for them to take over and change and move the direction, you know, turnarounds, they don't often turn, so they can be hard to do, but it doesn't mean it doesn't happen. You know, Satya and Adela did it at Microsoft, and so it definitely could be done. It's just, you got to give them time to do it. And I don't

think, you know, six months to a year is not long enough. You know, they need at least a couple years, if not, maybe a little longer. That's the way I look at it.

Andrew [00:27:58]:

Yeah. That makes all the sense in the world.

Dave [00:28:01]:

What are your thoughts? Do you have a tighter rope on them? Depends, as always. Depends.

Andrew [00:28:08]:

How much damage is there being done to the moat at the moment and how damaging was the culture itself and all of that versus, is the stock price just down and shareholders are just unhappy and theyre making it sound worse than it is. Like the Google thing.

Dave [00:28:26]:

Yeah.

Andrew [00:28:27]:

You know, all this chatter about AI and stuff, general public doesn't really care.

Dave [00:28:33]:

No, not so much. No. I mean, there was a lot of, there was a lot of noise when it first happened. Of course, there was a lot of vitriol and a lot of, you know, angst about how much that really impacted anything. But, you know, it feels like that Sundar got everything kind of under control and is kind of trying to make sure that those mistakes don't happen again. And time will tell whether he's been successful with that or not.

Andrew [00:29:05]:

But I honestly don't know what. I mean, I get those, like, angry bloggers and stuff, but the stock price went down. Like, that's the only thing I see.

Dave [00:29:14]:

Right, right. I don't think the misstep really, it doesn't, I don't think it materially changed what they do, how they do it, and how they'll continue to do it going forward. Does it make people, maybe make some people

that were on the fence about the company, maybe more uneasy about it. Sure. But YouTube is still YouTube. Google search is still Google search. The ads are still doing what they do. Cloud is becoming a monster.

Dave [00:29:47]:

I mean, if you look at those things, you know, it looks like the future is bright for the company. So that's, I mean, that's the way I would look at it. It's the way I do look at it.

Andrew [00:29:58]:

Yeah, same. I don't know how we got on this tangent. Maybe the moral of the story is, like, some yellow flags that people think are yellow flags are actually white flags.

Dave [00:30:12]:

Yes. And likewise, some that maybe people don't think are yellow flags are actually red flags. And so, you know, it can kind of go, it can kind of go both ways. And some of it, I think it's just perspective, and some of it is just our biases or our emotions creeping in, too.

Andrew [00:30:31]:

Where would you put blanking on the term? I wanted to sound all financial and cool, but I'll just settle for like, a big balloon payment that a company's getting in the next year or two. Like, it's so big that there's no way they're going to pay it off unless they can refinance it.

Dave [00:30:48]:

Yeah.

Andrew [00:30:48]:

Do you put that in yellow or red territory?

Dave [00:30:52]:

I think. Well, I don't know that you could. I don't know that I could put it in a definitive, I would probably put it in, you know, kind of between whatever the color is between yellow and red. Yeah. And some of that would have a bearing on, to me, would be a bearing on how management is dealing with it. In other words, is it something that they're talking about so that shareholders are aware that this is something that's coming up? Because to me that sends a signal. A couple things. Number one, that they know that it's coming, and

number two, that they have a plan for it, you know, that they're talking about, this is what we're going to do, or this is what we'd like to do.

Dave [00:31:34]:

I think if, if management communicates that to you, then that would be more yellow flagish stuff. If it's something that you notice and you see other analysts asking you about, but they don't ever really answer the question or they're kind of evasive about it, that would probably tend more towards a red flag for me because that's not great.

Andrew [00:31:53]:

Yeah. The company I'm thinking of has never mentioned it and no, no analyst has talked about it.

Dave [00:31:59]:

Really?

Andrew [00:32:00]:

Yeah.

Dave [00:32:01]:

Okay. That would feel more like a red flag because it's obviously going to impact the business. And if they're not talking about it, it's not just going to go away, it's going to come and they're going to have to deal with it. And I guess that would, you know, that maybe could be a, we always look for signals of how there's not a lot of hard, fast rules to determine how aligned management is with shareholders. And so a lot of times we look for subliminal or more discrete signals to tell us, you know, hey, this girl likes us or this girl doesn't like us, you know, kind of thing. And so sometimes when management maybe doesn't talk about certain things or glosses over certain things, that can be a bit of a red flag. I came across, I was listening to a podcast. Our friend Brett and Ryan were talking about trade desk, and they noticed in trade desks annual meeting that some analysts were asking them some tougher questions about some capital allocation and maybe some different things, and that management basically didn't answer the questions.

Dave [00:33:15]:

They just literally ignored the questions. And so instead of explaining some of these things which other people know about, they just chose to ignore it and just tried to be all happy and upbeat during the whole presentation as opposed to being honest and just, you know, sitting down or not sitting down, but explaining

or trying to allay anybody's fears about those things. And to me, that sends a subliminal message that they're not on the same page with me. And because that, that could affect the stock price big time. It may not affect their pay, but it could affect my returns. And let's say this is a 15% port of my portfolio and I'm set to retire in two years, and they kind of unknowingly know that, that the company is going to go through a rough term and they're not telling me, or at least giving me a heads up. That's not great.

Andrew [00:34:08]:

Yeah.

Dave [00:34:09]:

So that's, that's kind of how I would look at it.

Andrew [00:34:13]:

Yeah. I sold Domino's pizza because of the balloon payment, which I haven't, haven't seen. For all I know, it could be refinanced tomorrow, you know?

Dave [00:34:25]:

Right.

Andrew [00:34:26]:

It's just. Couldn't stomach that checking over my shoulder every quarter. Did they refinance it? Did they refinance?

Dave [00:34:32]:

Right. Nope, nope, nope. It's something they're going to have to deal with. And the fact that they're not being open and communicating with it with you about it, I would much, much, much rather have something bad happen and management CEO be upfront about it. Just stand up there, say, yep, we messed up. We screwed up, whatever, and just be honest about it, you know? And that's one of the things that I, like, love about Buffett and Munger is when they make a mistake, they say, yeah, I was dumb. I was stupid, you know, why did I buy Dexter shoes? Why did I give away part of the company? I diluted the company, and, you know, so I make you less money, and then I made a bad choice. And, you know, so when he stands up there and says those kinds of things, it tells you that he's speaking from, you know, integrity, and it makes you feel like he's on your side, kind of thing.

Dave [00:35:21]:

And there's other CEO's, I'm blanking on examples at the moment, but there's plenty of them that I've listened to that have had horrible quarters, and they come right out and say, yeah, that was terrible. I mean, Jeff Bezos is one that springs to mind. You know, his annual letter the year after their stock price dropped, like, 90 some percent. You know, the first. The first words in his, you know, was, you know, you know, so he's. He's not ignoring that we had a bad quarter, we had a bad year, and the stock price dropped a lot. And these are all the things we're going to do to get us back on track. And so, to me, that gives them more integrity in my eyes.

Dave [00:36:03]:

So more of a yellow flag would be if he just ignored the fact that the stock price dropped 94% and.

Andrew [00:36:10]:

Just try to act like everything was.

Dave [00:36:12]:

Fine, bury the head in the sand, just ignore that something bad happened kind of thing, and just, you know, move on.

Andrew [00:36:19]:

Yeah.

Dave [00:36:20]:

Yeah.

Andrew [00:36:21]:

I love when a CEO is good at, like, answering dumb questions, too, you know?

Dave [00:36:26]:

Right.

Andrew [00:36:27]:

I feel like every earnings call, Jamie Dimon's on, he's explaining that we're here for the long term, like, asking me about trying to get a crystal ball out and.

Dave [00:36:38]:

Right.

Andrew [00:36:38]:

I don't know where interest rates are going to go in three months, so stop asking.

Dave [00:36:42]:

Right.

Andrew [00:36:42]:

Every time. Every time. It's awesome. He hands on a grace. It's awesome.

Dave [00:36:47]:

Yeah. Right, yeah. The CEO for LVMH, the, um, the luxury company, uh, Bernard Arnaud, he faces, they don't give out guidance ever. And so he. Every quarter, there's, you know, an analyst was asking him, you know, can you give us guidance? Nope. He just shuts them down right away. You know, he's French, so they're a little more blunt than Americans, but it's just. Yeah, it's funny.

Dave [00:37:12]:

It's the same question. He. These are right up front. I'm not, we're not going to do it. They still ask like they're hoping that maybe they can trip him up. You know, they can trick him into, oh, yeah, we're going to grow. Oh, sorry. All right.

Dave [00:37:26]:

Any other yellow, red flag, yellow flags you wanted to throw out there that.

Andrew [00:37:30]:

Probably covered the big ones for me?

Dave [00:37:33]:

Yeah, yeah, yeah. Really? The only other one, I guess, would be dilution.

Andrew [00:37:37]:

Oh, yeah. It's a good one.

Dave [00:37:38]:

Yeah. So that, to me is, that's not great. Touching on companies that are aligned with shareholders. Dilution basically means that your share of the pie is getting smaller because they're, they're offering more shares to people. They're offering more ownership to people that, and you don't have any control over that. And so they're basically shrinking your piece of the pie. So if you once had an 8th of a piece of pie, then it goes to a quarter, or, I'm sorry, a quarter of pie, and it goes to an 8th and then a 16th and a 32nd and so on. And that's what da ocean does.

Dave [00:38:11]:

And the bigger, the two biggest, I guess, proponents of that, or not proponents, the two biggest culprits of that are usually stock based compensation and the compensation that the management gets. And those are usually the two biggest culprits. And stock based compensation is an line item you can see on a cash flow statement. And so you can see how much money they're giving out. There's, if you want to start a war on Twitter or X, all you got to do is say you can be bullish on stock based compensation or bearish either direction, and you're going to get a firestorm. So buyer beware. But the, that is where the biggest culprit is. And it's really hard to see, especially when you have really strong companies like meta, for example, that are spending a lot of money to buy back shares, but really all they're doing is trying to offset the dilution or the stock based compensation that they're giving out.

Dave [00:39:08]:

And I understand that it's part of paying people in the tech world and whatnot and getting skin in the game for employees and buy in and all that kind of thing. But what about the people that are investing in the company? What about the shareholders? What do we get? So it could be hard. I think there's a levels of dilution that are okay, but you got to be, you just got to be aware of it. And it's something you gotta kind of crack. And if you see it start to, if it continues to escalate, then to me, that escalates to a red flag. If it stays kind of where it is, then it's just kind of yellow flag and maybe is more annoying than anything else, but it's not something you're going to see in Berkshire, but it's definitely something you'll see in meta or trade desk

or a palantir. So it'll vary a little bit by industry. You're not going to see it in an energy or utility company, for example.

Dave [00:39:53]:

So that, to me, is a yellow flag.

Andrew [00:39:56]:

Trey, what about issuing shares for an acquisition? What are your thoughts there?

Dave [00:40:00]:

I don't like that either. I think that's a yucky, yucky, yucky way to acquire companies, because, again, you're diluting the shareholders, the people that have already put their money into your company. Now you're saying to them, well, you know what? I don't generate enough money, and I'm not willing to take a pay cut. But you're going to take a smaller bite of the company because I want to own this business, and I'm thinking directly of now block. But Square bought a buy now pay later company called Afterpay for a cool $29 billion, and they did the majority of the purchase in shares, which means they diluted the shareholders of Square. And a year and a half later, ironically, square or block was worth less. Their market cap was worth less than afterpays was. So that, to your point earlier, thats basically taking a whole bunch of money and just throwing and lightning on fire.

Dave [00:40:57]:

And thats, to me, is very bad capital allocation. And so when youre thinking about investing in companies and you see them do those kinds of things, yeah, run far away, that, to me, borders over into a red flag, for sure. Not just because that particular situation, but just using shares to buy companies is not great.

Andrew [00:41:17]:

Do they get the impairment yet?

Dave [00:41:19]:

No, no, no, not yet.

Andrew [00:41:22]:

Gotta be coming.

Dave [00:41:24]:

Yeah, I'm sure at some point that.

Andrew [00:41:25]:

Sounds like it's priced in, though.

Dave [00:41:27]:

Yeah, right.

Andrew [00:41:29]:

Geez, that's bad.

Dave [00:41:31]:

Yeah, it's very bad. It's very bad. So I guess the last takeaway from all that is sometimes the people that are running the business maybe awesome at other parts of the business, like creating products or creating services or tech that people love, but they may not be great at actually running the business. And a lot of times you have to remember that the CEO's, when they become the CEO, a lot of times they come from a different world. Like, they may be a marketer or they may be in distribution or something, and they, they have no idea what capital allocation is or what it's like. And so they have to learn on the job. And that's why that is so important to crack and pay attention to and things like how they treat bad news or your ROic or the dilution or how much they're willing to dilute shareholders. Those are all subtle signs of how good or bad management can be.

Dave [00:42:35]:

And so those are all things to keep in mind. That's why it's so important to find great companies that are run by really good people.

Andrew [00:42:42]:

Amen.

Dave [00:42:43]:

Amen. All right. Well, with that, we will go ahead and sign us off. I hope you enjoyed our back to the basics and the yellow flags that you should look out for. There's a litany of other ones that we didn't even get to. So maybe this will be something we might talk about again in the future. But. But we'll see.

Dave [00:43:01]:

But with that, we'll 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. Bye.

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