Back to Basics: Ranges of Outcomes in Investing

Dave [00:00:00]:

All right, folks, welcome to Investing for Beginners podcast. Today we're going to go back to the basics. We're going to talk about range of outcomes. So every Thursday we do a back to the basics episode, and we talk about some foundational aspect of investing to help you build on the fundamentals so you can become a better investor. Today's topic is ranges of outcome, and I'm going to turn it over to Andrew, and he can help us define that, and then we can go ahead and chat a little bit. So, Andrew, when we think about ranges of outcomes or range of outcomes, what does that mean to you?

Andrew [00:00:35]:

I think this is something that's really good for beginners to wrap their head around. I wish somebody grabbed me and, and told me these things when I first started. But do you really have very high risk, high reward stocks and companies and much lower risk, lower reward companies, and a lot of it has to do with how far down a company lifecycle a company is or an industry is. So a lot of times in the earlier high growth phases, you do have a higher chance of return, but there's also a lot more risk in the sense that there's more failures. You know, five most exciting businesses in an industry that are growing at warp speed, not all five are probably going to survive to the end. They're probably consolidate to maybe two or three. And so if you're left holding the bag on one of those that fanned out, it can be really detrimental to your results. And then the flip side of that is when you get down to the two or the three companies leather left, sometimes it can be hard for them to grow much faster than the economy, or even sometimes it becomes hard for them to outgrow the economy.

Andrew [00:01:51]:

And then you can get stuck in something that's maybe not dead money but not returning you as much as maybe your opportunity costs would have liked. And so that can be also a bad investment for you, depending on what price you pay. And so kind of in general, those are the ways I think about it. There's totally exceptions to the rule and can have several groups of companies that can kind of bend away from

those kind of generalities. But the numbers of stocks that actually do that are probably a few handfuls versus you have thousands of stocks that we can choose from. So the odds are not in your favor at finding the exception. So we just have to be cognizant of that and be aware of it and invest accordingly. So maybe starting with the life cycle idea, how do you define it and how does that impact the range of outcomes of a stock?

Dave [00:02:51]:

Yeah, that's a great question. So the life cycle I try to think of, you think about maybe a dog can be a good example. When you first get your puppy and is really, really small and young, it's very energetic, kind of hyper maybe not controlled very well, like potty train, for example. All those things are like a really young company where there's lots and lots of potential. You can see in a puppy's feed how big the dog could potentially be because the paws are huge, right. And it's kind of the same with a new business. It's coming into an industry that's ripe for lots of growth or lots of expansion. And you can see the horizon is really beautiful.

Dave [00:03:41]:

And then as the dog gets older, it's still a puppy and it's potty trained, but it's still young and it still has a lot of the energy and activity. Loves to play, you know, loves to wrestle, wants to run a lot and whatnot. And that's kind of the same with young companies. So they're maybe beyond the, I guess, super growth stage, but they're still growing pretty darn fast. And then as the puppy gets older, it starts to mature, but it still has some of that playfulness left in it. It still wants to be energetic and have lots of activity, but it's toned down from what it was the two other life cycles ago. And as the puppy continues to age, it goes through this life cycle like a company will, where the, the range of outcomes is going to start to narrow, where as the puppy gets older, it still may like to play, but maybe not every day. Maybe it's only a couple days a week or three or four days a week.

Dave [00:04:39]:

And then as it gets older, maybe it only play, wants to play once in a while, and then when it's really old, then it doesn't want to play at all. It just, you know, the dog wants to sleep a lot. And so you can see that kind of evolution of how a being ages. And I think of the same way as companies. You can't compare a young company like a Celsius to a company like Walmart, because where they are in their growth stage or their stage of evolution of businesses are vastly different. And so the range of outcomes is also going to be vastly different. You would never expect Walmart to grow at 45% a year if it did. Holy moly.

Dave [00:05:20]:

So thats not going to happen. But the same token, if you see a young growth company like a Celsius growing at four or 5%. That would also be a situation of concern. You can see how the lifecycle can have a big impact on what your perception is and what your expectation is on the range of outcomes for any particular company. I guess that's how I try to think of it. What about you?

Andrew [00:05:46]:

Yeah, I think that's a great way. I like how you said, I think the puppy and the young stages can kind of be all over the place and wants to do one thing 1 second and then something else the second after. In the case of the puppy, I had to take care of it, wanted to pee and then poop or no poop and then pee while I was picking the poop. So that's always fun, right? The thing with, you know, not to pick on Celsius, I have no idea how that whole story will play out. You know, for all I know, it appears to be a great drink. But just because a company has a great product doesn't mean that it's going to be a great investment for the next ten or 20 years. When you have a company that's very young, they might be super ambitious, so they might. For all I know, Dulcie's could be the best energy drink that we've ever seen.

Andrew [00:06:35]:

But what are they going to do with that cash? And that's the thing that you don't know until after the fact how that's all going to play out. So, you know, sometimes the ambition of the founder can be its downfall. And a lot of what would have everybody thought, oh, this is going to be great profits, great cash flow, and all of these things can all get put into something else that was not even what the original company was. I'm thinking a block, as an example. It probably happens more often than we hear about, and you don't hear about it because it kind of happens quietly over time. And so these once great businesses that could have been the next Walmart end up kind of just fading into oblivion because the capital is not allocated in the ways that would help shareholders. So even though you have a great business, you have a great product, you don't get a great result as a shareholder because capital allocation was screwed up, or a lot of different reasons, a lot of ways the puppy runs that make it so it doesn't turn out like you would think.

Dave [00:07:36]:

Yeah, exactly. What are your thoughts on this idea? We're talking about young companies and kind of the ranges of outcomes. One of the things that I think about with some companies is maybe the industry that theyre going into, and this is from no research, no real sense of the industry. Again, to go back to Celsius, I feel like the ultimate range of outcomes for that company feels more constricted than it would for industries like when Uber went public, or when the cybersecurity, like a crowdstrike or Palo alto networks or cloudflare, or even Tesla have a much bigger range of options or ability to continue to grow. Where I feel like a company like a Celsius may have a little more narrow of a. I hate the word tam, but the range of

outcomes or the opportunity to grow in a more extended period of time feels more limited to me with them than it would with some of these other companies that are expanding or creating industries in things that are not really. They're kind of groundbreaking, if you will. What are your thoughts on that?

Andrew [00:08:51]:

Yeah, I would say in general that's probably the case. It just. It makes sense if the dollars are there to take and there's more dollars there to take, you have a higher avenue for growth. But, you know, to look at, like, a company like Celsius. I was looking at yeti this morning, and I kind of think of it kind of like Celsius in the sense that that sounds really niche. It doesn't sound like there can be a huge tam for that. I mean, they've got water bottles and coolers like, what's the tam? But they just made a couple acquisitions, are getting into high end cookware, and they're also getting into travel bags. And so now, all of a sudden, they're opening up these lanes of tam that were not there two, three years ago.

Andrew [00:09:37]:

And so I would say, in general, yeah, probably the general rule is the bigger tams will be easier to see. But on the flip side, with good capital allocation and maybe some smart strategic moves, you could get a tam that expands much faster than people expect. And so if the price is right, the valuations there, sometimes that can be a great opportunity. Look at monster beverage. It's been one of those great compounders that everybody talks about, but for years, investors just all pointed at it and they said, this is a fad. People aren't going to drink energy drinks forever. This is going to go away. And they just proved not to.

Andrew [00:10:16]:

And their tam continues to expand as I continue to do more and more things. So, to get on the tangent, but kind of going back to the bigger tam, when you mentioned the bigger upside, those probably have a bigger range of outcomes, too, in that if everybody in the world is raising capital to make a cybersecurity startup, and there's ten other people who just ipo that are all in cybersecurity, they're not all going to be winners. And so one of the downfalls of having a huge tam or having an industry with huge profit margins is everybody sees it and everybody wants to go for it. So to your point about the higher range of outcomes, not only on the reward side, think about the risk side. It's going to draw a lot of competition. And that's why you can see so many of them fail, because the bees want to go where the honey is. And you know, being niche can sometimes keep you away from some of those range of outcomes that are on the downside.

Dave [00:11:18]:

Yep. I wonder if that's why cloud computing and AI have been so popular recently. Because it seems the speculation is that those are boundless opportunities for companies. And to your point, it seems like every

time you turn around now there is some new fancy AI ability of things that you never dreamed that would be possible, or just popping out of the woodwork. It seems like one pops up and then 15 more appear. And in our space, it seems like I come across one that can consolidate earnings calls into a shorter synopsis or summary, and now all of a sudden I like see seven of them. I don't feel like that's an investible space per se, but it just shows the potential. And it also makes you feel like there's just this huge range of outcomes that could come from those particular sectors and ideas.

Dave [00:12:20]:

Yep, a couple of things kind of pop to mind when I'm thinking about some of these ideas and concepts. Number one is how can we try to identify what we think a range of outcomes could be for a particular business or a particular industry? And how do we maybe measure that?

Andrew [00:12:41]:

That's a really good question. I think if you're in the kind of higher risk tolerance thats kind of in your blood and youre down to get beat up a little bit, I think thats going to be the secret sauce right there. Is answering that question really how wide of a range of outcomes are we talking about and trying to analyze that? Its not much different than trying to analyze is this mature business with three competitors there? Is it going to sustain for the next ten years? You can take a similar thought experiment with a younger company. You just probably have to gather more rocks and turn up more of them over to look at really all the different businesses. But if you can start to pinpoint some of the reasons why, okay, this is why this company is doing really well. This is why that company is doing really well, that can start to help you see if there's a narrower range of outcomes, or is this literally the same product that when you people are producing, and it's basically like a commodity and who knows what the winner is going to be. So hopefully, with some deeper dive research, you can start to determine those things and see if it's the type of risk reward range of outcomes that you're looking for.

Dave [00:14:02]:

Right. Do you feel like with the younger companies in particular, that you have to take more of a shotgun approach in that I'll just pick like this, the cybersecurity space, there's a huge opportunity, because as the cloud continues to become a bigger, bigger part of how we do things, there needs to be security for that. And as that gets bigger, the opportunity for more bad stuff happening, you know, the surface area for more bad actors to act becomes a bigger and bigger idea. And then so people are going to need more and more protection against the bad actors and, but because it's also new, the cloud is newish, and cybersecurity is newer ish. And so it's, it just, to me, it feels like it's really hard to narrow down who you think is going to be the winner, because who you think is the winner now may not be the winner in six years. And so I just

wonder, do you need to take, if you're going to invest in that kind of style, do you need to take more of a, throw a whole bunch of money at a whole bunch of different rocks and hope that one of them becomes the winner? Or do you try to pick the winner?

Andrew [00:15:19]:

That's tough. I mean, you want to talk about playing the hard game, which is trying to play games where there's high range of outcomes. Now you want to throw a whole nother thing where you're in the tech space, where things in tech can change in seemingly milliseconds. And so I don't have a good answer for the tech thing. Um, tech's just really, really hard. And there's just been some tech companies that have seemed easy in hindsight, but tech in general is really, really hard. So I really can't, I can't help anybody there. But when John Templeton, I don't know if we've talked about him much.

Andrew [00:15:55]:

Hes one of those kind of like deep, maybe not deep, but definitely a value investor kind of cut. He looked at a period of time, I think it was after the Great Depression maybe, where so many stocks were cheap, and instead of trying to pick and choose, he just bought like 50 of them. I think he was like literally Im going to buy 50 of them that are trading under a dollar share and that was his thing. And I dont know if it was international or in the US, but there was a huge value at the time and that's what they did. And so that worked really well because you had a huge range of outcomes. When a stock is so cheap and beaten down there's a decent chance maybe that it goes into bankruptcy or maybe that it just stays down and never comes back up. Value trap or a pretty decent chance that there's just a lot of fear in the market and then things are going to pop back up. So when you take an approach like that in the value space where theres a lot of high range of outcomes with these super deep value plays, the only, I mean other than Buffett who like had the deep value grand slam with American Express during the salad oil scandal, other than that, most of the value investors I hear that are going super into the deep value, high range of outcomes kind of plays are buying big baskets, taking that shotgun approach like you're saying, and understanding that a few of these are going to lose money or not do anything, but I'm going to get a bunch of huge winners because there's just so much fear in this marketplace.

Andrew [00:17:33]:

So I would imagine there's ways to do that on the growth side as well. Sequoia and some of those guys are really good at that. But I don't know enough about playing that way to say what kind of industries that is very conducive to or not. It's just outside of my circle of competence. Right. Do you have thoughts on the whole shotgun kind of idea?

Dave [00:17:57]:

I spent enough time trying to learn about the cybersecurity area and it feels it borders on the too hard pile to I kind of think I understand it, but trying to the fine edge I'm balancing. But it also feels like I'm struggling to find, okay, this I think is going to be the winner and, or do I, I've been indecisive I guess is the best way of putting it about whether I should pick one or if I should pick four or five and just kind of go with it and see, you know, equal weight them and just call it a day and move on with my life. And so that's one of the things that I haven't really come to any conclusion on. I think about a little bit about Peter lynch and I think a little bit about Joel Greenblatt and John Templeton. I should consider as well that have had larger portfolios with lots of companies and they're smaller portions of their, like their position sizing is smaller of a lot of different companies, and maybe that's a way to play it. And as the companies mature, then maybe you can define what you think is going to be a winner and start to increase your position size. That's a thought I've had as well, but I really haven't come to any conclusions. Honestly.

Andrew [00:19:24]:

I think Charlie Munger would say invert the problem. What are the reasons that a shock and approach in that industry would not work well? What are the reasons why that group of investments will not perform well over the next ten years?

Dave [00:19:37]:

Well, there's a few things that kind of spring to mind when I think about averting my struggle. One would be that there could be some failures. So let's say I pick five, for example. Two of them could fail and maybe the other three consolidate, like two consolidate and the other one peeds. And if I choose poorly and maybe bet bigger on the two that fail, then I could struggle to get a good return from those companies. The other, I guess, real problem right now that I struggle with a couple of the companies is theyre so crazy overvalued that I dont necessarily want to pull the trigger on them, but they could end up being some of the winners. And so that's where I struggle on the knife edge of do I, am I missing something? And do I understand the businesses well enough to know that, hey, I think these two are really going to be the winners, but they're also trading at 120 pes kind of thing. And so it makes it hard, you know, the other ones are air quote cheaper and, you know, respectively when they're only 45 pes versus 120.

Dave [00:20:54]:

But they may be either the losers or not the ones that I think will be the winners.

Andrew [00:21:00]:

How wide is the range of outcomes of that industry becoming profitable someday?

Dave [00:21:06]:

I think the likelihood is quite high just because of the nature of the business models. Most of them are subscription based and they're building brands that people recognize as being quality products. And they're also doing it in a way that they're enticing people to come into their ecosystem and then people are, once they're in the ecosystem, are leveling up. So they're, they're expanding their spend with each company and those numbers keep growing year after year. And at some point soon they're going to start to, a couple of them are going to start to hit an inflection point where they'll start to become profitable because the revenue growth will start to outpace the costs that it takes to run the companies. Theyll get to the point where therell be enough recurring revenue that they dont need to have as many salespeople for example, they can start to scale some of that back and thatll start to allow them to be more profitable. I think.

Andrew [00:22:15]:

Are the barriers to entry high? Can you and I make one tomorrow and ipo it and take some of their market share?

Dave [00:22:23]:

That is one of the things that I'm not 100% sure on because I'm not a tech person per se. It seems from the outside like yeah, there's no way I could do that. But the fact that you see all these companies popping up that can do that, it makes me feel like that it could become commoditized at some point. Like the, the tech is not differentiated enough that it's that vastly different.

Andrew [00:22:48]:

Right. That would be where I would focus if it was something I was seriously considering like one potential downside. Not to say that this is going to happen, but what if you spread into five now and then the 6th one goes ipo tomorrow but you didn't get that one and that's the one that wins. Right, right so, right but if the barriers are there where the five that you've identified really have these barriers and nobody else can come close, I wonder if thats a higher expected value outcome depending on what price you pay for everything.

Dave [00:23:27]:

Right? Yeah, I mean thats a great point. The other thing that I havent mentioned that I have to consider is that I think if you take all five of their revenues, it still is less than what Microsoft does annually, so.

Andrew [00:23:44]:

Or their security segment.

Dave [00:23:47]:

Yes. So that may not happen forever. But you know Microsoft has a big, it doesn't get a lot of love. I think. I think people in the tech industry probably think that Microsoft's particular security tech is not great and that could just be the perception because the CEO for crowdstrike is fairly critical of Microsoft in his earnings calls or whatnot. So maybe I'm just being biased by that particular point of view. I just don't know enough about Microsoft because it's not something they discuss much. And so I'm not sure kind of where they sit.

Dave [00:24:24]:

Are they the biggest just because they have the biggest opportunity space and they have the most customer facing people that they can entice to come into their ecosystem in that respect or do they really have a great product and that's why people use them? I'm not sure yeah.

Andrew [00:24:44]:

And so those are probably questions to answer for people when they're considering these. All right, so we kind of have the not sure camp. Right? And then I talk about, like, the deep value idea. Are there any range of outcomes that you would say? Definitely. I would never even touch these because the range of outcomes are pretty close to gambling. Like the draftkings of the world, the drafting and the fanduel and MGM and some of those.

Dave [00:25:17]:

Yeah.

Andrew [00:25:17]:

How do you think about, like, doing a shotgun approach at stocks like that?

Dave [00:25:21]:

I would avoid that at all costs, I think something like that. I think there's a couple of ways you can look at some of those. Number one, that industry, it's not a gambling, is certainly not a new industry, but maybe the online gambling in the form that it is right now, feels like it's very or very, very early innings here in the United States in particular. And so it just feels like there's really no way that you could necessarily pick

which of these is going to be the winner. And it also feels to me a little fetish. And so I wonder if long term, if that's an industry that will stay legitimate. My biggest worry in that respect, I'm not a gambler, but my biggest, I guess, worry in that space would be some sort of tragic gambling thing that happens a la, the 1919 White Sox throwing the World Series, something of magnitude of that level. You know, New England patriots throw a super bowl, you know, and how dramatic and how tragic that could be.

Dave [00:26:38]:

That something like that could, I think, could really tarnish the industry and maybe even at some point. Cause maybe it's not just a Super bowl. Maybe it's a whole season or seasons, a bunch of teams in the league, not just one team, but maybe half the league decides to throw games kind of thing. And it just really throws into question the impact gambling has on sports and, and whatnot. And maybe people, the backlash is we can't have this anymore. It's obviously too dangerous. So that's, I guess, my soapbox answer to something like that.

Andrew [00:27:11]:

Is the narrative similar to that? I mean, I could probably check the valuations, but, like, does that narrative pervade or is that contrarian viewpoint?

Dave [00:27:22]:

I would say its probably more contrarian viewpoint than the narrative. I think those companies are probably extremely popular, especially among the more gambling incentive type investors, no pun intended. But I think people that are more willing to step out on a ledge and take a chance on companies hitting it big would probably be more inclined to invest in those kinds of businesses. Like, I'm not sure how much you're going to find Vanguard or Blackrock investing in those companies big time. They could, but I don't think you'll see them putting as much money into them as you would in AI, for example.

Andrew [00:28:06]:

Yeah, I mean, I guess it depends on who you talk to. The question would be, is the experience you get on draftkings or fanduel that much better than a traditional casino? And then can these traditional casinos not come up with their own versions? And is draft, Keynes and Fanduel that much better than any of those new entrants? So we're back to the barriers to entry again, right?

Dave [00:28:33]:

Yeah.

Andrew [00:28:35]:

What the range of outcomes could be?

Dave [00:28:37]:

Right? I think the range of outcomes could be huge for not only the online gamblers, but the more brick and mortar casinos because then they would have, if they see, I'm sure they're seeing the huge growth in the online casinos of the gambling, that they're going to want a piece of that pie and they'll probably be able to figure out a way to, I doubt if there's a huge barrier to entry to create a platform that allows you to gamble like that. There's probably some regulatory things that need to be hammered out. But if they already have a gambling license, I would think that that would be an easier path. But I dont know that specifically. Its just speculation.

Andrew [00:29:23]:

Yeah, I dont know that specifically either. But that would definitely, I think, play a big part in the whole barrier century discussion. And I think that really ties into why some of the more mature companies have lower range of outcomes is because a lot of these companies that are in very concentrated, mature industries have massive barriers to entry. Like you and I are not going to make our own competitor to Walmart tomorrow, raise a bunch of capital, do an IPO, and then try to compete merchandise by merchandise with a Walmart down the street. It's just not going to happen. And so the chances of Walmart's free cash flows that they're earning today just disappearing tomorrow is much less than some of these other growthier names that we've just discussed. And so yeah, they're not going to ten x tomorrow, but when you have companies with high barriers to entry in more matured markets, you can count more on those cash flows than you can something thats newer. And thats a big part of why the appeal of those as investments can be quite high, because youre not gambling with your money, youre doing stuff thats pretty safe.

Andrew [00:30:50]:

I mean, yeah, stuff doesnt work out, of course, but all in all, if the barriers to entry are there, and your moat is decently strong. You can continue to compound at a decent rate for quite a while. For a lot of these businesses, it's easy to raise capital. It's much harder to build a lasting moat. And great companies don't raise capital forever, Robert.

Dave [00:31:15]:

No, they do not. They do not. I mean, think about the barrier to entry, to start a railroad today, like, you know, or telecom company, you know, to compete with at and T, Verizon and T Mobile. It's just, you know, or, I mean, to this point, I mean, this, you know, to give props to Elon Musk, to start a car company and be successful with it, today's age, day and age, not easy. And you can come up with all the tech you want, but, you know, to vitality. Ketch and Ellison's point, you still gotta bend metal, still gotta build the cars, and that's very capital intensive. And you and I are not going to go out and create a car that we can build and manufacture without a lot of money. A lot of money.

Andrew [00:32:05]:

Yeah. And there was no guarantee that he was going to succeed. So a lot of the EV makers have crashed and burned. There's a pretty decent chance that some of the legacy guys could have not allowed Elon to come through. So we all wish we got in on that, obviously. But the range of outcomes were severe. I mean, in the book, Elon Musk, they talk about how the company was less than 24 hours away from bankruptcy, and Elon pulled off a miraculous capital race. That's how close we were to everybody driving for lightning f 150s instead of Teslas on the road today.

Andrew [00:32:45]:

That's how close. 24 hours.

Dave [00:32:47]:

Yeah. That's a very narrow range of outcomes.

Andrew [00:32:50]:

Right.

Dave [00:32:51]:

Yeah. The knife edge that they were operating on at that point shows you how hard it is to start a company and how hard it is to be successful at a company. It's not easy. All right, folks, well, with that, we will go ahead and wrap up our conversation today on a range of outcomes. Please come back every Thursday as we go back to the basics and help you teach you some fundamental outcomes and theories and ideas that can help you become a better investor. So 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.

Dave [00:33:25]:

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

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