Brian Feroldi Joins Us to Give Us 8 Reasons the P/E Ratio Sucks

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Dave

0:00

All right, folks, welcome to Investing for Beginners Podcast. Today, Brian Feroldi and I are going to record live from Cincinnati, we are at the EconoMe fire conference. And we're going to do a live show. Today's is something I've never done before.

So Brian and I are going to talk about the P E ratio and why it may suck, or why it could be. Okay, so there's some interesting information that he's going to share with us. So, Brian, thank you for joining us for our first live show. Again, Andrew, we'll be back next week. This is just a temporary deal. So don't freak out people. So this is

Brian

0:30

awesome. I love coming to conferences, especially money conferences, getting to meet people like you in person for the first time. So this is a lot of fun.

Dave

0:36

Yeah, it is. Yeah, we're definitely looking forward to this. So Brian, you got some great information you want to share with us about the P E ratio, and maybe why it may not be the optimal metric to use. So could you kind of talk us through maybe the basics of the P E ratio, and then we can kind of work through maybe why it's not so great.

Brian

0:53

Sure. So the P E ratio is one of the most widely used valuation metrics that exists. In fact, I think for decades, it was the only metric that was printed in newspapers for like people could use to look at how expensive or cheap a company was. It's a metric that I absolutely love. And when I first started investing, it was the hammer that I applied to every nail investing nail that I saw. And the unfortunate thing about the P E ratio is that there is a whole host of reasons while using the P E ratio, the P E ratio is a completely flawed metric. And if you rely on it solely to make investing decisions, you can make bad decisions just like I have many times.

Dave

1:33

All right, so maybe Can we talk through what the P E ratio is? So for people out there that are new to the show, and are familiar with this voodoo that we're talking about? What is the price earnings ratio?

Brian

1:43

Sure. So P E ratio stands for price to earnings ratio, it's simply a measure of the difference between the price per share that a stock trades at and the earnings per share that a company produces. In theory, it is a single number that shows you how expensive or cheap a given stock is a good rule of thumb is that the s&p 500 has traded at an average P E ratio over the last 100 years of about 15.

So just knowing that if you came across a stock that traded at 25 times earnings, you would say that that is expensive when compared to the average market multiple. And if you came across a stock that traded at five times earnings, that would be historically cheap, when compared to the the average market multiple. So it's a very good shorthand tool and a number that you can look at and quickly assess whether a company is cheap or expensive.

Dave

2:39

Okay, awesome. Awesome. All right. So I know that the P E ratio has many uses, but there's apparently there's three kinds of P E ratios can you kind of talk through those real quick

Brian

2:48

Sure, broadly speaking, the types of P E ratio depend on what that E is in the denominator, what kind of earnings you are using the bottom. And there's several different E's that you can use in the bottom, which changes the flavor of the P E ratio that you're looking at. So the most common P E ratio to look at uses the E, which is the T T m earnings. TTM simply stands for trailing 12 months earnings.

So essentially, it takes that company's most recent income statement looks backwards one year adds up all of the earnings per share of that last year. And that's what is the number that is often referenced, which makes sense that is actual data. Looking backwards. However, some cases investors like to use what's called forwards.

The P E ratio, which is dividing not by the actual numbers of the actual earnings of the companies looking backwards, but the estimated earnings that a company will have looking forwards and that can either be over the forward one year meaning starting from today, how much money is that company going to earn over the next 12 months, that's an L it's another P E ratio that you can have. Or you can have one that uses the next calendar years earnings. So for example, we're recording this in March of 2023.

One forward P E ratio could be okay, what is the price of the company today divided by the estimated earnings per share that that company will earn in calendar year 2024. So that would be the forward P E ratio. Oftentimes, it can make sense to do that. Because if a company's E is rapidly changing, because the company is say growing, you can get a more normalized look at the P E ratio. So there's just a couple of different flavors that are out there.

Dave

4:30

All right. That's awesome. So for an investor to figure out like the trailing 12 months or the past, E ratio makes sense. But how does the average investor look at the forward P E ratio? Do those numbers come from the company? Do they come from analysts do they come from thin air? Like where did those come from?

Brian

4:48

Yeah, it's more analysts and thin air than the company themselves. The companies themselves don't report their earnings or their estimated earnings over the year at least I've never seen a company that did that know what I really believe in a company that did that too. Probably the place that those forward estimates come from are the analysts themselves. So analysts that cover companies, they typically create pretend what they forecast misstatement to look like this year, next year, and so on.

And that's where comes from typically, the P E ratio, the forward P E ratio that you see published on websites like Yahoo Finance is kind of the average estimate that analysts have for the next year. And that so that makes it slightly more accurate, since it's an average of a bunch of different analysts as opposed to just one person's opinion.

Dave

5:30

That makes sense. Cool. All right. So we kind of teased at the beginning that we're going to talk about the P E ratio, and what's wrong with it. So what's wrong with the P E ratio?

Brian

5:37

Yeah, I think there's many things that many reasons that the P E ratio can be leading, but they all get to the bottom number of the equation, right. So again, P E stands for price to earnings, and the price is known a number there's no debating that. The tricky part about investing in using the P E ratio is that the E the stated earnings of a company that is using that calculation can be wildly misstated when compared to reality for a huge range of reasons.

So if you are looking at the P E ratio, and the actual earnings power of the business isn't fully captured in the E, you could get a price to earnings ratio that looks dramatically overstated in some cases, or you can get a P E ratio that looks dramatically understated in some cases. And if you don't understand that nuance before you rely on the P E ratio, it's very easy to look at the P E ratio in absolute terms and make the wrong conclusion.

Dave

6:36

Okay, that makes a lot of sense. All right. So let's talk about the eight reasons why this all can happen.

Brian

6:43

So reason number one is because of something called accrual accounting, accrual accounting, which is the accounting method that is used to draw up an income statements. Accrual accounting is the standard way that income statements are created. And what it does is it shows a company's profitability. In theory, it really smooths out a lot of the the ups and downs that business can have from just making their operations to showcase this principle are really simply pretend that we owned a company and we were building a factory together, and we were going to create products from this factory.

And we spent $100 million on this factory. Well, investment that we made that 100 million dollars, does it make sense to put that on our income statement in year one? Well, you could argue no, because that factory has a useful life of 20 or perhaps even 30 years. So while the cash out of our pocket would be $100 million. On day one, that asset is going to have a useful life of 20 or 30 years. So the way that accrual accounting works is you only expense a tiny portion of that factory on the income statement to give you a more complete view, or more complete estimate of what the earnings power of the business big. So let's get back to the example let's say we spent $100 million in the factory, we expected that factory to last 20 years.

Rather than saying in year one, our expenses are $100 million, what we would do is we would say in year one, our expenses were $5 million. And we would include that $5 million expense every year for the life of the factory, in this case, 20 years. And the way that we record that expense is something that is simply called depreciation which everybody that owns and operates a car understands. Well, that is just one example of the difference between cash accounting and accrual accounting.

And there's a whole bunch of different reasons why the accounting numbers in an accrual accounting, and the numbers in cash accounting can be wildly different to throw out some other terms that can show a huge difference between the cash flow of business and the stated earnings of a business. There's things like accounts receivable and accounts payable, there's amortization, there's things like deferred revenue and asset impairments, there's the hot topic of stock based compensation or inventory, which a lot of companies are dealing with the effects of COVID.

But essentially, when you're thinking about the income statement, that is kind of like an accountants opinion of the earnings of business. And that opinion can be wildly different for a variety of reasons from the actual cashflow of business. And if you don't understand that dynamic, you can again, look at that P E ratio, which could be overstated or understated because of the simple, cruel accounting and you can make a completely wrong decision.

Dave

9:31

Yeah, that makes a lot of sense. So can we back up for just a second and maybe talk about the like an overview of the three main financial statements and maybe how they flow into each other because I think that idea of the income statement being an accounting statement, and not an actual cash statement, I think can confuse some people so maybe you could maybe kind of understand why people maybe how that kind of flows from one to the other.

Brian

9:56

Yeah, absolutely. It's again, let's let's use the three statements and go over that. that pretend factory that we said that we built. So let's say we go out and we buy this factory build it and it cost us $100 million in cash, we have $100 million sitting around. Well, on our balance sheet, we would list this asset, this 100 million dollar asset. In our long term in our long term assets. A balance sheet is simply a federal statement that measures what you own and what you owe, it's kind of like your business's net worth.

So we will list on our balance sheet, we have this 100 million dollar factory that we expect to live for 20 years, well, then we operate the factory for a full year, we record our revenue from the sales of the products and we record all of our expenses. And the bottom line, there would be the earnings or the net income of the company.

And that is where the P E ratio is derived from the actual earnings on the net income statement. But as we said before, we're only going to take a minority a small portion of that factory, and we're going to depreciate that on the income statement. So on the income statement, you would see a $5 million depreciation charge for that factory each and every year for the next 20 years.

However, on the cash flow statement, the cash flow statement is very similar to like your checking account. So the only thing that the Cash Flow Statement cares about is did money come in to your checking account, or did money leave your checking account. So on the cash flow statement, in our first year, we spent $100 million building our factory. So our cash flow statement would show a big fat, negative $100 million outflow the statement because $100 million actually left our account. So think about that for a second on our cash flow statement minus $100 million for this factory. And on our income statement, we only say it only cost us $5 million.

That is a massive difference in the expenses that we were recording for itself. Now, conversely, the cashflow statement in years 902 through nine to 20 would have zero outflow for that building, because it doesn't cost us additional capital where it would be recorded on the income statement. So over a long enough time period, the cash flow statement, and the income statement will converge with each other because they are reflecting the accounting realities in different ways. But in the short term, they can diverge greatly.

Dave

12:16

So let's move on to Reason number two equity investments.

Brian

12:20

Yes. So a few years ago, the rules of accounting changed. And what happened was a companies that own publicly traded stock in other companies now on their income statement have to mark up their net income when those investments go up in value, and they have to mark down their net income when those investments lose value. So a real simple example of this is a company a very popular company called Shopify. A few years ago, Shopify bought an equity investment in a company called a firm a firm is a payment process company that breaks out big payments into smaller pieces as a company.

Well, when a firm became a publicly traded company, it now has a quoted stock price. And a firm's stock price has been extremely volatile, just like many companies that have come public over the last couple of years. So in 2021, when a firm came public Shopify recorded on its income statement, a massive gain because a firm stock became public and went up a lot.

So Shopify is investment in a firm marked up the company's net income, which had a dramatic impact on the company's earnings, and hence an impact on the company's price to earnings ratio. Well, over the last year, a firm's stock has fallen dramatically, like so many text zombie companies have. And Shopify now has to record that on its income statement. So if you look at the earnings of Shopify, they went down dramatically in 2022, simply because a firm's stock went down in 2022. And this is now happening with lots of companies.

Berkshire Hathaway owns lots of publicly traded companies, Google owns publicly traded companies, Amazon has a huge position in a company called rivian. So for those companies, and many others that own

an equity stake in another company, the earnings of those companies are essentially now useless, because the earnings will be dramatically impacted based on what happened to the stocks of the companies that they own. I would argue, does that really matter to figure out the earnings power of the business and hence the P E ratio? No. So if a company you're looking at owns an equity position in another company, that's public, that company's P E ratio is all but useless.

Dave

14:50

Yeah, yeah. I totally agree. Berkshire. There was definitely one that is a company that I own and I'm very aware of the fluctuations of the earnings with that company and that's why it's almost comical to see that People react favorably or unfavorably when his portfolio goes up and down, and how much it impacts the earnings of that company, but really has nothing to do with the performance of the businesses that he owns. So yeah, that's a great point. All right, one time events. That's number three. So can you tell us about that?

Brian

15:15

Yeah. I don't know about you, but has, have you ever gotten an unexpected bonus, or you ever want a small lottery payout, or you ever had an inheritance of some kind? Right? Good. One time things can happen to us all in life, and they are can be completely unpredictable? Well, unfortunately, or fortunately, the same thing can happen in businesses, sometimes businesses have an asset that increases in value, and they choose to sell that investment, or sometimes they make a one off deal.

Well, the way that the income statement works is whenever a company gets a one time windfall, from an asset sale, or from a tax gain, or from any other one time event, they have to temporarily increase the value of their income. So a couple of years ago, for example, in 2018, Starbucks sold its consumer goods business, that consumer goods portion of its business to nestle for $1.4 billion.

So Starbucks no longer had the ability to sell their products, consumer goods stores, Nestle essentially bought that business. Well, that transaction gave Starbucks a $1.4 billion, one time windfall during that period, which artificially inflated its earnings by $1.4 billion. Well, what happened to the P E ratio, during that time, earnings were temporarily high, so therefore, the price to earnings ratio was temporarily low.

So if you were in this period, and you're looking at Starbucks as P E ratio, you'd be like, gosh, the P E ratio here is only 15. Right? That is a bargain bargain for a company like Starbucks, it's never been that cheap.

However, that windfall was off the books the next year, and then the P E ratio returns to its normalized number. But if you are making a decision in a period where a company has a one time event that's impacting earnings one way or the other, again, the P E ratio is just going to be wrong. Yeah,

Dave

17:13

that's awesome. A great, great example. All right, let's move on to unsustainable trend. I think this is probably one of my favorite ones,

Brian

17:19

right? So sometimes businesses create products or services that are going through an unnatural boom times. I mean, there's no better example of this than I can think of in recent years would be what happened to Etsy, in 2020. The demand for Etsy is platform skyrocketed in 2020, because everybody needed a mask, all these sellers came to market and they were selling masks, and they were taking advantage of this one time boom, in sales for homemade goods.

So Etsy is revenue and their net income absolutely skyrocketed in 2020. Well, because their revenue and net income, we're writing this one time unsustainable trend, they're a P E ratio, their earnings exploded, and that cause their P E ratio to shrink, even though their stock was increasing the time. And again, if you were just looking at the P E ratio during that period, you could make an argument that their earnings power, the actual earnings power of the business was overstated, because it was writing an unsustainable trend.

Another time that this happened to me specifically was back in 2014, a company called Gilead Sciences launched two blockbuster drugs that cured hepatitis C, it completely cured hepatitis C, which was amazing. And the sales for these drugs were just astronomically high. There were millions of people that had hepatitis C, and they went out as soon as they could, and got this cure for hepatitis C. So during this period, Gilead Sciences revenue and profits exploded, I'm talking about revenue more than tripled and profits more than 10x during this period.

And I looked at the company's P E ratio and saw it was trading at six. I was like, the P E ratio here is six. And this company is growing a 300% per year like does it get any better if you are an investor, but what I didn't realize in the market did was the company was writing an unsustainable trend because after it cured these patients of hepatitis C, they didn't need to buy from Gilead any longer, which is wonderful for humanity, but it

just artificially inflated Gilead earnings. So again, if you're looking at the P E ratio to make a decision, like I was you ended up losing money.

Dave

19:35

Yeah, that's a great example. And you know, it's great for humanity to be like you said, but the company not so much. All right, let's move on to the next one cyclical demand.

Brian

19:46

So this one is particularly tricky. Some industry sell goods and services that are just naturally prone to booms and busts. A great example of this more recently would just be the energy markets, if you've pulled up a long term chart of say oil prices around the globe, you know that they go up sometimes and then they go down. Other times it is literally a yo yo.

And demand. It's not that the demand for oil is moving around that much. It's just that when oil prices are high, companies are incentivized to go out and find more oil. And they usually find more oil, which brings a flood of new oil to the market. And that causes the supply demand to be imbalanced, and that causes prices to tank and then prices stay low for a bit.

So the profits the profitability of companies that have cyclical demand, because of some commodity prices aren't very predictable. And because they're not very predictable, during boom times the earnings absolutely skyrocket like last year, when oil prices went through the roof because of the the war in Europe, the profits of Exxon and Chevron just absolutely skyrocket because oil prices and energy prices went extremely, extremely, extremely high.

So if you're looking at a cyclical company, at that peak, oftentimes its P E ratio looks extremely low. And that's the markets way of saying the earnings here is not sustainable. The earnings here are riding cyclical upswing, and eventually they will fall down as energy prices decline. So if you're investing in a company that has maybe their gold maker, or they're investing in some commodity that has a cyclicality to it, or it's an industrial company that does very well when the economy is running hot, but demand evaporates when the company is going strong in for those companies, the P E ratio will literally always tell you the wrong thing, the P E ratio will be very low at the cyclical peaks.

And it'll be extremely high at the cyclical bottoms. So you literally if you're going to use the PE ratio, you have to do it in reverse, when the PE ratio is low, that's the time to sell. And when the PE ratio was sky high, that's actually the time to buy.

Dave

21:57

Yeah, that makes a lot of sense. So can you list off maybe a couple other industries that might be considered cyclical beyond something like a commodity or something like an industrial?

Brian

22:06

Yeah, it is really any business that does not have recurring revenue to it. And the real thing to ask yourself is what happens to the buyers behavior when a recession comes. So basically, anything that is non discretionary typically has a boom or bust cycle to it. So an example would be the travel tree, when everybody has a job and money is flowing, like the demand for travel tends to be really high.

But when a recession comes along, that's often one of the things that people pull back on naturally. So the travel industry would be a one. But the key thing to ask yourself is what happens to the behavior of the buyers during bad times. If it's toothpaste and soap and toilet paper, you're going to be buying that no matter what is happening. But if it's a luxury good and consumers can delay the purchase, that is typically when the P E ratio isn't going to be the best.

Dave

22:55

Okay, that makes a lot of sense. All right, let's move on that kind of I guess segues into the next one. industry dynamics. Yeah,

Brian

23:01

there is a couple of industries out there, despite their very nature, the income statement is not the best way to judge their progress. And the most famous one out there to me would just be the the financial sector, and specifically banks and bank stocks, if you are going to be analyzing the banking industry, the income statement isn't useless. But it is not the financial statement that you should focus on, you should be focusing very heavily on the balance sheet.

But that is where all the secret sauces for the banking industry. So I didn't understand this years ago, when I would look at companies like say, Wells Fargo or Bank of America. And I would see they'd be trading at P E ratios of like six or seven. And I'd be like, well, well, that sounds great, right? These things are so cheap, and they pay high dividends. Well, what was the P E ratio of Silicon Valley Bank two or three weeks ago, I don't know.

But no matter what it was, it was a useless metric for figuring out if that company was a buy or not. Another industry that comes to mind is just the biotech sector. The way that that industry works, is companies often spend hundreds of millions of dollars over the course of a decade to research and get a drug to market. And once the drug comes to market, if it's a winner, like it can quickly sell hundreds of millions or even billions of dollars. So if you're looking at the P E ratio of those companies during their development phase, you're gonna get a negative number, because they have no earnings.

And yet some of these companies with awful looking financials can actually become fantastic investments if their drug ends up by hitting it big time. And the last one that I would say is the real estate investment trust market, any company that takes advantage of the tax laws associated with REITs. Oftentimes, those companies are taking enormous depreciation charge on purpose to keep their earnings on artificially low. So it just doesn't work in those cases. But again, this is the kind of the nuances you need to understand.

Dave

24:56

Yeah, that's, that's perfect. All right. Let's move on to number eight. This is on questionably my favorite chart you have here the eight business growth cycle. So let's talk about the business growth cycle.

Brian

25:05

Yeah, this is something that super confused me, and I would say would be the number one reason that I have gotten the P E ratio. Wrong. Broadly speaking, if you think about the business growth cycle that a company goes through that company that becomes publicly traded, there are some fairly predictable things that are going to happen during that company's lifecycle.

So think about a company that is a startup, let's say me, and you had an idea for a market opportunity, and we wanted to go after it. And we needed venture capitalists of funds to take advantage of this market

opportunity. Well, it's very common for companies that are in the startup stage to have essentially no revenue, or maybe a teeny tiny bit of revenue. However, they are often hiring like crazy in order to build out the infrastructure that they need to take advantage of this opportunity that they see. This is a lot of tech companies that we've seen come public for the last couple of years, are kind of in the very early innings of their business growth cycle.

During this stage, it's very common for them to show bottom line losses, right, they are losing money on the bottom line on purpose, because they're using venture capital funds or outside capital to fund the business to get to increase the scale. So they can take advantage of an opportunity they see companies that successfully make it through that tough period of losses, then their next goal becomes breakeven, right coming up with essentially getting to zero on the bottom and get to the point where they are no longer losing money, which is a major accomplishment if a company can get there. But a company that reaches that that breakeven point after a couple of years, what is the earnings of the business at that point, is essentially extremely low. And once the company has earnings, because the earnings are so low, the P E ratio finally becomes a number right, it'd be kind of becomes a number that you can see.

And oftentimes, the P E ratio of these companies like Amazon in the mid 2000s, or Google in the 2000 10s, looks insane, it looks like it's 1000 or 500, or often in the hundreds. And if you look at that number in isolation, you're gonna save yourself No way, I am not buying a company that's trading at 1000 times earnings.

That is just insane. The thing that I missed and think that took me a long time to understand is that companies that just become profitable, are not focused on generating maximizing their profits. Oftentimes, companies that just become profitable, are focused on maximizing their revenue. And because of that, the price to earnings ratio is not the right metric to look at. However, as Africa becomes profitable, it is common for the business to shift its focus towards profitability, to really squeeze out as much profits from the revenue that's generated as possible.

And it's only after that process is over. And the company is fully optimized for earnings, that the true earnings power of the business is stated. And hence the P E ratio becomes useful. So for decades, I heard people saying Amazon's price to earnings ratio is crazy. It's 200, it's 500. And they passed on buying it, and the stock kept going up and up and up and up. And it actually proved that buying at 100 times earnings, or 1000 times earnings was fantastic. And the thing that people got wrong, including myself for so long, is Amazon wasn't focused on profits, it was focused on revenue, and Amazon's P E ratio will only become useful once the company is focused on profits.

Dave

28:48

And who knows when that'll ever be gone. I think this is probably one of the more insightful ideas of all the things that we talked about today, because the business lifecycle dictates what the company is doing. I was reading a 10k the other day, where the CEO said specifically, we will not focus on profitability, until we feel like we get our sales maximize.

And we're going to spend every penny to have our operating income be zero or to be flat or operating margin to be flat or negative, because we want to keep investing to grow the business. And now that I understand that, I thought that was a brilliant assessment. But a few years ago, I probably would have been like, okay, yeah, past so these guys nuts. So I think this idea of the business growth cycle is so critical to understanding not only how to value the company, but also what stages are in and what to expect from the business as they're going forward. I I love this idea that you guys came up with, I mean, kudos to that. Oh, awesome.

Brian

29:47

Yeah, this is really important. And there's nothing wrong with investing in companies that are losing money. There's nothing wrong with investing in companies that have a very high P E ratio, and there's nothing wrong with saying to heck with all that. I'm going to wait until the company actually has profits, and I'm not going to invest till then that ladder is exactly how Warren Buffett invests Warren Buffett only looks, he really focuses on companies that are already optimized for profits, he wants to buy companies that have gone through all that hard work.

And they are as close to assure thing as high as you can get. And he has a fantastic track record. So you can do very, very well, by only focusing on companies that have already reached the profit maximization phase, the tricky thing that investors get into is they're looking at companies that are in breakeven phase, or they're in the investment phase. And they are looking at the P E ratio and saying, Well, this is an insane number, I'm not going to use it. It's not that it's an insane number. Instead, it's simply too early in that company's growth phase for the P E ratio to be to be useless

Dave

30:50

to be relatives. Yeah. So alright, so we spent all this time, almost 30 minutes talking about how useless the P E ratio is. And people are probably listening to us go on date, Brian, what am I supposed to do? So what do people do? What should investors do?

Brian

31:05

Yeah, so the P E ratio is actually my favorite valuation metric to look at, which might be funny when giving, ever just said knocking it. The real thing that you need to keep in mind, though, is that you have to ask yourself, is the E in the P E ratio a real number? Is it an actual useful optimized number that is dependable for the long term?

If the answer there is yes, the P E ratio can be a great tool, a great shorthand for figuring out is this company a bargain or not? The tricky thing, as we've discussed is that there are many, many, many reasons why the earnings power of a company will be understated and the P E ratio won't be useful. So the key thing to do is to first figure out what stage of development is the business in. And the second thing to figure out is, what ratio or what metric is most useful for measuring that company's value, depending on which stage the company is in.

So if a company is in the startup phase, the real thing to look at is the company's total addressable market opportunity. This is something that venture capitalists look at all the time, if the company is in stage two, which is in the hyper growth phase, the only really metric that you could look at to figure out is a company of value is called the price to sales ratio, it's the ratio of the company's market value to its sales per share, when it's in the self funding phase.

So when it comes a breakeven, that's when you can use other metrics, such as the reverse discounted cash flow model, you can get fancy with a discounted cash flow model, or you can look at other nonprofit metrics, like gross profit or operating profit as a metric. But it's really only once a company becomes fully optimized for profit, that things like the price to earnings ratio, and the price to free cash flow ratio become irrelevant metrics. So it's just critical to understand how the business growth cycle works. So you don't use the wrong metric at the wrong time.

Dave

32:56

Yeah, that makes a lot of sense. Okay. All right. So let's move on to item number five disruption.

Brian

33:02

So this is one that can be particularly tricky to think about. But it's going to become increasingly important to realize this trait, especially as we move forward, because I believe that right now, we're in like one of the most disruptive periods in human history, given all the changes that we're seeing. But essentially, sometimes a company's earnings or the business can actually enter a permanent state of decline, because the company's core business is simply being disrupted.

And this is actually a very critical thing for investors to understand. Because if that company's business is being disrupted, no valuation metric will save you think back to think back to the period of 2003. I don't know what the numbers are. But I can guarantee you that blockbusters price to earnings ratio looked pretty, pretty attractive, right? However, what was about to happen to Blockbuster over the next five years, that company got disrupted by Netflix. So it doesn't matter if you paid one times earnings for blockbuster in 2003. Within a couple of years, you lost 100% of your investment. So the if a company is actively being disrupted, the P E ratio is just utterly useless, very big company that this happened to over the last 10 years was General Electric, GE if you look back to the period of 2007, General Electric's P E ratio was 14.

This is a big blue chip, like super blue chip company very dependable, all that kind of stuff. And if you you could have picked made the argument that 14 times earnings for General Electric is fairly cheap. Well, if you bought in 2007, at 14 times earnings, you had to stomach a 90% loss over the next 14 years.

And the reason is, a couple of General Electric's business units got completely disrupted. And the company went through the financial crisis which which had which hobbled that greatly, but General Electric's earnings, the EA, were essentially at a at a peak, and they have been declining ever since. So if a company is, if their earnings are slated to permanently decline moving forward because of disruption, the P E ratio won't save you.

Dave

35:16

Okay, all right. Well, Brian, that was amazing. I love the overview of the P E ratio and all the ins and outs of it. And I can't stress how important it is to understand what it is you're looking at. So you look at it in context and be able to figure out what's going on and really focus on that business cycle, because that will help you determine what kinds of ratios you could use, instead of just taking one and trying to fit that square into

every circle. It's better to try to use the different tools instead of the hammer for every nail, trying to use different tools for different nails.

And I think that's so important. So you guys have fantastic resources, you have YouTube videos, you have Twitter, and you also have this fantastic newsletter that you guys just sort of created. Can you tell me more about that? Yeah, so

Brian

36:02

me and my business partners, who are both named Brian send created a very simple newsletter that goes out once a week. It's called long term mindset. And if it in it, we just tell one investing lesson.

And we share graphics that we make related to investing. And we also share a couple of links to timeless investing content that we think investors should know. So if people are interested in that, they can just sign up on my website, which is Brian farley.com.

Dave

36:26

Yeah, and it's awesome. I signed up a while ago, and I read it every weekend. It's it's a nice short synopsis, and they have great stories in there. And it's fantastic. I really recommend people, check it out and subscribe to it. So it's worth worth your time. For sure. So Brian, thank you very much for joining us today. This was a lot of fun doing our first live show. So it was kind of exciting and it was a lot of fun. So you imparted a lot of great wisdom as always, so thank you for that.

Brian

36:52

Awesome well thank you for having me and awesome to be the first in person interview so awesome. But don't worry Andrews coming back soon.

Dave

36:58

Yes, he is. Alright. Alright guys. So with that, I'll go ahead and wrap it up. You guys go out there and invest with a margin of safety emphasis on the safety. Have a great week, and we'll talk to you next week.

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