IFB267: How to Measure Liquidity in Investments

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Dave

0:00

All right, folks, welcome to Investing for Beginners Podcast. Today we have episode 267. Today, Andrew and I are going to talk about how investors can avoid losing money in risky investments. We recently were working on a very large project over the last few days working on some metrics and numbers related to the E letter portfolio. And Andrew and I came across some ideas we thought we would share with you guys today. So without any further ado, I'm gonna turn it over to Sir Andrew and we'll go ahead and get our conversation started.

Andrew

0:30

Thanks, sir Dave, let's dive in. Yes, we were deep in spreadsheets. So I'm gonna try my best to speak English for this episode. apologize in advance if I end up speaking a different language

Dave

0:41

Ctrl F everything right.

Andrew

0:45

Let's start though, let's say somebody's an absolute beginner. They this is unfortunately, the first episode of ours they've ever listened to just in general. And even for the investor who kind of wants to just take a very hands off approach to their investing. How could they avoid risky investments? Let's start there.

D

Dave

1:05

Ooh, that's a good question. I think probably the best way that I can think of would be to find companies that do not have negative earnings. So look, for companies that are growing revenues, growing cash flows, have positive earnings over the last few periods don't have more debt than they can handle.

In other words, one of the quickest ways to find out whether a company is in trouble is to look at their interest coverage, which is a metric that you can use that can determine how much operating income so how much money they make from their operations, do they have to pay to service their debt, in other words, make their interest payments on their debt. So when we think about debt and interest payments, you think about the amount of money that you have the Oh, and every month you have a payment you have to make like if you have a car loan or a mortgage, that's your payment, that's your service payment you have to make.

And if you don't make your mortgage payment, then you run into trouble. Same thing applies with businesses. And if a company runs up too much debt, then they can run into trouble and have struggles paying that debt payment. And so by looking at an interest coverage ratio, which is basically measuring the interest expense a company has versus the operating income, or the money they generate from production of their product, whether they can cover that payment easily or not. And the higher the number, the better, that means they can easily cover the payment.

And that's when companies can run into trouble. So that's, I guess, one of the things that I think, would help a beginner investor look that's maybe more like, bordering on advanced or not advanced to like bordering on intermediate. But it's certainly something that stood out to me from looking at what we just looked at over the last couple of days, I feel

Andrew

2:57

like the interest coverage ratio is something fairly basic, and one that can be easy to use. And I would say if investor out there doesn't want to look into a metric like that, or look at any metrics at all, I don't think you should be picking individual stocks. And I think you should stick to more traditional ways to reduce risks, sort of like just diversifying, you can buy a big basket of stocks.

And basically those might go up and down over the years. But over the long term, as the economy grows, your investment will grow. So I would encourage you the listen to our back to the basic series, if you want to know why the stock market's a great place to have investments in. But if you don't want to dive in, you should probably hit pause on this episode, because we're gonna dive into some metrics. So you mentioned the interest coverage ratio. Can you give an example of like a company, we'll have to pull up the real numbers now, but sort of like, compare and contrast? A very good one and a very bad one? Okay, maybe start with a company that we might know. And then maybe we can do an example of something that won't be

Dave

4:07

that good, right? Well, let's, let's take our friend at Apple, for example, Apple would be a company that does have debt on their balance sheet. They do make payments on the debt on a quarterly and annual basis. And the company also generates a ton of income from selling the iPhone, iPad, I watch I everything, and they do really well. And it's a company that has, you know, I won't go into the nitty gritty of the numbers. But just looking real quickly. We see interest coverage ratios of 3537 4123 over the last three plus years. And those indicate really high coverage, they're easily able to make their payments even if their income dropped dramatically.

They still would be able to cover their debt payments and would still be able to get continue as an ongoing business. And so that gives you a good idea that, hey, this is a strong business. And this is a company that's going to succeed and survive for a very long time. There was a company recently that I was looking at it was wicks, or wax wax industries. And it was, it's a company that focuses on debit cards and credit cards for payments for fuel. So like the trucking industry and things like that. So super sexy business. Joking, of course, but one of the things that I noticed when I was looking at their financials was that their interest coverage was really, really low. And when the pandemic head, they actually fell below it, and they had to borrow even more money to make their interest payments.

And so their interest coverage when I was looking at them, this was several years ago, they were bordering on less than one, which is not good. And it was for several years in a row. And so they were taking on more debt to try to boost the revenues of the company by investing more and things of that nature. But the investments weren't working out. And they had bought a couple other businesses in hopes of juicing their returns, and it wasn't going well. And so during the pandemic, they actually fell below their interest coverage.

So they actually owed more money than they were bringing in, which is never a good place for anybody to be, and especially for a company. So they ended up having to take on more debt to try to make the short term

payment. And so that was not ideal for sure. Have you noticed anything? Any companies out there like that, like on the good and bad end of the spectrum?

Andrew

6:45

Yeah, plenty. And I feel like those are like two perfect examples of really illustrating the extremes and coverage ratio. And you might ask, you know, okay, what's the big deal for a company taking out a bunch of debt, you know, you start talking about $750 million, a billion dollars, like, who cares, it's just numbers at that point. But that is a perfect example of what happens when a company takes on too much debt. At a certain point. If you take out too much debt, and you're not finding good uses for it, and you're not able to generate returns from it, you enter a situation like that, where now you're teetering on the brink of bankruptcy. And even if you do save yourself, it's almost like you've mortgaged your future. So it's really do or die at that point.

Dave

7:28

Exactly. I think another factor to kind of consider when you're thinking about the debt situation and the interest payments, is it also reduces the amount of money that a company has for earnings, which they can use to reinvest in the business and the more that they spend on the debt. And the less income or the less net income or earnings that they have, they can run into trouble where they can go negative on the earnings, which means that they have less cash flow to reinvest in the business. And that can also lead to the company going out of business as well.

And that's it, haven't you told us like 1000 times that negative earnings is like the number one reason companies go out of business, bankruptcy companies can recover from, because they can go into bankruptcy court and and get help with kind of restructuring and whatnot. But negative earnings, that's another hill to overcome. And that's a lot harder one to overcome. Because now if you're losing money, people aren't going to want to loan you money, a bank is going to be like, you're not making money, and you want to borrow from me, how are you going to pay me back like they're not going to, and so they're going to be less likely to give it to you. If they go out in the bond market and try to raise money by selling that they're putting out there, people are going to end that's kind of risky, because the company is losing money. So it's just never a good situation. So that's, I guess another component of this kind of idea of debt in the wrong hands can be bad.

Andrew

8:47

And as people invest in the stock market, if a company goes into bankruptcy, they could reorganize and become that company again and everything will be fine. But the people who lose in that situation, are you the shareholders because your investment goes to zero, the company might live on. So do not tread lightly on the fact that having a company that approaches bankruptcy or is in bankruptcy is really, really hard to come back from and that can really hurt your investment returns for the long term. Yeah. Okay. So let's move to what would be another metric that would be good for avoiding risky companies. Well,

Dave

9:26

I guess the next one that I would look at would be the current ratio, which is a measure of the company's current assets versus their current liabilities. And the easiest way to explain those is current assets are liquid assets or more liquid assets that accompany within the general framework is within a year, the company can liquidate and usually you think of things like cash on their balance sheet, you think of inventory, you think of accounts receivable, maybe other assets that can I'll get lumped into those. But those are the general ones that people think about, like you think about Walmart, when they buy the toys that they put on toy shelf.

Generally there, the idea is that they're going to sell those quickly. And they're going to turn that inventory into cash. And that's kind of how that works. And the same idea with current liabilities. So that's money that you owe. Assets are things you own, like I bought those toys, Walmart bought those toys, they sit on their shelves, that's theirs, until they sell it. The liabilities is money, I owe people. So the toys that I bought from the producer, I owe them money for that. So that's what's called an accounts payable. And that means that I owe that toy manufacturer money.

And so those are debts that you owe, and it can be accounts payable, it can be deferred revenue, it can be accrued compensation, so payroll that our people, and it's not that Walmart's not paying people, it's just that the way the balance sheet works is when they produce a balance sheet, it's a one day snapshot in time. And so that day, they may have not paid payroll for the quarter or for the period or for the, you know, the two week period, or however Walmart structures, their payroll, and so they have money on their books that they owe the employees. And so that's a debt, that's the easiest way to think of again, these are assets and liabilities are money they own and owe that are due within a year that they're liquid.

So that's stuff that they can easily turn into cash, if perfect example, the pandemic, if everybody shuts down, and there's no business, like the Carnival Cruise Line, for example. They think that's the kind of the perfect illustration, they literally had to shut down business, they had zero income coming in. And so now they have

to live off of the current assets and current liabilities on their balance sheet. Because the long term permanent asset is a boat. That's not something you can go down the street and sell right. So it's not liquid, ie they could sell it, but the amount of people out there that they can buy it and would be willing to buy it is very limited. And so the idea that it's not a liquid asset, and so I think that's kind of the way I would look at it. So now that I've beat that dead horse, I guess what does the current ratio tell us? Like if we're talking about I own this, and I owe this? What does that mean to investors,

Andrew

12:24

that basically means if a company has healthy liquidity or not, and liquidity is important, because like you said, sometimes things can freeze up during a crisis, or during like the Great Recession, we saw, like during the pandemic, we saw things freeze up. And so if you hold stock in a company that has less liquidity, and you do see a crisis, those things can go down a lot quicker and start to snowball into a lot of bad things. I feel like I use this example all the time. But the example of Circuit City of a company that had a decent current ratio, but because a lot of its current assets were inventory, that suddenly people did not want because of the Great Recession, they ended up having to go bankrupt, even though they were a pretty fast growing company. So these things do play an impact at a certain point.

And if you want to, so as an example, I watched Domino's Pizza go down 10% today. And if you are somebody who doesn't know, the financials, and like how their balance sheet is, you might worry is this company in trouble? Are they going to disappear on me tomorrow? But when you know, yes, the 10% loss wasn't so much people worrying that they're going to go bankrupt as it was they did not meet expectations, then it's a lot easier for you to hold on to stocks, that inevitably will go down at some point. So having that kind of knowledge is power can be very helpful and knowing that the company, like Dave was saying could cover their short term liabilities with enough cash on hand, that can save a company from making a lot of dumb choices,

Dave

14:10

a lot of dumb choices. And I think one of the things that is interesting about talking about kind of the current ratio is it gives you a really quick snapshot of how liquid the business is. And like Andrew was saying, when things go south, that stuff becomes very, very important. And you hear people throw the term around strong balance sheet all the time. And one of the ways that you can determine how strong a balance sheet is by looking at that ratio of the current ratio, current assets to current liabilities, and the best thing about it is it's super easy to calculate because it's literally on the balance sheet.

For 99.4% of the companies. We discovered that the last few days not all of them do this but 99.4% of the companies out there whist current assets and current liabilities on the balance sheet you don't don't have to do any fancy math, you don't have to add this add that you don't have to understand the ins and outs of every single line item, you can just literally look and see it says current assets at the top of the page, and about halfway down current liabilities. And then you just compare the two numbers to each other, you just divide the current assets by the current liabilities, and it gives you a number. And I guess let's talk briefly about the number. Like what is that? What are we looking for what what's good and what's maybe not so good?

Andrew

15:28

I would say anything, at least one is enough to make me feel safe. Yeah, for the simple fact that it's like, okay, for everything I owe, I at least owe or at least own something. So I'm at least covered on the minimum basis. Right. So you know, when you get 2.5, sometimes it's not as good when you get to two, that's kind of like really, really healthy. There are a few businesses that might have a lower current ratio.

And in that case, you have to consider the nature of the business. So as an example, a grocery store, unless they somehow buy all these bananas that all of a sudden people don't want to purchase anymore, I think they have a pretty good handle on. All right, we know we're going to sell through these bananas, right. So you do have to take that into consideration. But I would say for a vast majority of the companies, I would want to see a current ratio above one. Yep, I would

Dave

16:21

100% agree with that. And the idea that you may because of the way the balance sheet works, and when it's recorded, you may occasionally get one that may be a little bit wonky as far as the current ratio. And it's best to probably look at that over at least a five year period. So you kind of get a an idea that, okay, this is just an aberration, or it could also indicate that maybe something else is going on.

And it's a longer period of decline. So if you see it a two, and then it's a 1.5, and then one and then point seven and point five, that's probably not a good sign. But if you see healthy across the board, and you see one that's a little wonky, there could have been some extenuating circumstances. So try not to get too excited if you see it super, super low. Interestingly, Amazon and Walmart typically have current ratios a little over one to a little bit less than one. And that's just because of the nature of their business and how they operate their business. But, you know, if you see Walmart's at point, seven, four, don't freak out, it doesn't

mean that the company is doing poorly. It's just like Andrew was saying, it's the nature of what it does, lends itself to have kind of a little bit lower numbers that you would probably think they would have.

But then you look at Apple or something and you're like, Oh, my God, they got a three. It's like, okay, they're good. But I think the current ratio is really interesting. So I do we want to talk about what we kind of discovered through our project, as far as other forms of liquidity and how that could help people to go ahead.

Alright, so while we were doing our little project, one of the things that we kind of came across, that Andrew has been looking at for quite some time, but we kind of codified it and put it in spreadsheets, so that we can kind of track it with the companies that are in the portfolio are these ideas of using short term, I guess you could call it debt to help cover different expenses that the company may have when they have a timing issue with when they have cash versus when a bill is due. So for example, it let's kind of back up for a second and think about our own personal lives. Let's say that you have a bill coming due, and you don't quite have enough money. And if you have, sometimes people will use credit cards to cover that debt.

And then when they have the cash to go and back and pay off the credit card, because the money the cash that they get from work, didn't tie him up with when the bill was due. And so they don't want to miss the bill. They don't want to miss a payment get behind any of those kinds of things. So they use a credit card to cover that payment. And businesses are the exact same way. So they have two main ways that they can utilize this kind of short term, idea cash one is commercial paper. And the other one is a credit revolver, our line of credit. And for those out there that don't understand those terms. Can you maybe explain commercial paper and line of credit real quick,

Andrew

19:08

I feel like that describes it pretty well. It's just basically a backstop. Commercial paper is something that institutional investors can purchase. And line of credit is a account that they'll have with a bank. And with these bigger companies, it's usually a syndicate of banks, because we're talking about hundreds of millions of dollars, the commercial paper you'll really only see on the really big companies. And it's definitely can help to use a current ratio or make you feel better about the current ratio. So

Dave

19:39

you mentioned Walmart, you mentioned Amazon target is one that has a current ratio quite below one but they have commercial paper that's very highly regarded. And they also sell bananas. So you feel better about their lower current ratio. And it's because of things like that as well. Yep, exactly. And These types of liquidity that's exactly what this is, is those a commercial paper and a line of credit is a form of liquidity. It's something that the business can tap into when they have a short term crunch, like paying payroll, and the cash flow isn't coming in, that they need to cover it when the payroll is due. And so a company can choose to use commercial paper, or they can choose to use a line of credit to pay those off.

And that's very, very, very common to see in the business industry. This is not something that gets talked a lot about in the investing circles. And it's not something that I have ever seen anybody actually track with the businesses. And that's one of the things that Andrew and I were doing this last few days was working through the current ratios of all the companies that he and we own, and then also adding on this other extra layer of liquidity because that's money, like Andrew said, that target can tap into pay for the bananas as well as the payroll.

So I think bananas are going to be a common theme today. So but one of the things that makes it challenging to to find this is not all the companies will list, commercial paper or lines of credit, directly, most will again most, but not all will. And for me the one of the ways that I used to find it was our friend Ctrl F. And I would literally type in either three terms, one was liquidity, because in that liquidity section in the financial statements, they will list all the different forms of liquidity they have for cash and equivalents, other debt that they own free cash flow, but they will also list things like commercial paper and lines of credit. Now, sometimes, unfortunately, companies won't list that specifically in there. So then I would just type in commercial paper in the Control F.

And then you'll find 15, to 20 mentions of commercial paper, and you can find how much they have outstanding. Now some companies never ever use it. And some use it all the time. And it just you'll just kind of see it. But it's meant to be a short term gap. It's never something that's long. And so you may see it used one year, and you may not see it used in two other years. So it just kind of depends. But it's a using that little Ctrl F function to help you find these terms. And adding those to what you consider a part of the current ratio of the business will go a long ways to helping you find really great businesses that aren't going to go out of business because they don't have enough liquidity. And I think that's one of the things that we really kind of want to, to, I guess, hammer home today with the you know, the man with a nail man with a hammer always finds all the nails. So I think it's really, really important. And again, I want to give credit to Andrew for this idea, because this is something that's kind of floating around in the back of my head, but I've never done anything about it.

So you know, after the last few days it's become, it's now going to be a part of my checklist and my analysis of any company, whether it's a gym, or whether it's Walmart, I'm going to use these ideas, because I think they're very, very helpful. And it can help you avoid finding companies that don't have liquidity, and could be bad investments down the road. Because poor liquidity can lead to some big problems. And you're kind of seeing that play out a little bit with Intel right now, with they're struggling with with cash flow and having money. And they're cutting expenses and setting everything. And so you're kind of seeing it happen in real life, how not having enough liquidity can cause problems.

Andrew

23:27

So maybe the last kind of part of this, you talked about basically, in the short term, we got the pair interest you talked about, it's always important to be liquid. And then the last key that is really would be solvent. So more like long term, making sure that there's not too much debt for a company. And so give us like a very simple metric that somebody could start with and then maybe something a little more involved, if you would,

Dave

23:55

well, I think the easiest thing would be to the first thing I would look at would be a debt to equity ratio. And that you can easily calculate by totaling up the debt that the company owes, and then comparing it to the shareholders equity. And generally, the lower the number, the better the if you see a really, really, really high number, then that could cut, you know, that could give you a heads up that, hey, you might want to do a little more investigating into this situation.

Because something that we've learned along the way is not all debt is bad. And not a lot of debt is bad. Some of it depends on how, without getting into the nitty gritty of how the debt is structured. And that can help the company paid off in staggered amounts, just like us, you know if you if you buy a house for 250,000, but you owe all 250,000 In three months. It might be a harder nut for a lot of us to crack but you know as with a 30 year mortgage and you have a $2,000 a month payment that's a lot more feasible. So same rule applies with businesses so that equity is a super easy ratio to calculate and You can find it on just about any financial website stratosphere.io being one that can help you quickly determine whether the debt is too much or not.

Andrew

25:10

So maybe now that's a great one. I think that's a great place to start. And I like to look at not only the absolute number, which ideally would be below one, but obviously for lots of reasons that can go above that. But also one that is not trending in the wrong direction. Without having like a good reason to do it. A good reason in my mind would be, they're doing a lot of buybacks, but they're responsible buybacks. We've talked about irresponsible buybacks a couple episodes ago.

So that would be an okay reason for the debt to equity to be going up. But in general, it's something you would you would want to flag to say, I better understand why this that's equities going up. And why it's not indicating that the business is getting more and more risky, because a lot of times it does indicate that right? The more advanced version, I would say would be you could use a net debt to EBIT da ratio, which all its law, the letters, but all it's really saying is how much debt do they have? And then how much do they earn in the on the year to year basis? And is that a comparable amount? So from what I've heard seen on the internet, something like a three and a half net debt to EBIT da or lower is preferred. Ideally, you would have zero net debt, which means they have more cash than they have debt. But like they have a saying there are responsible ways for companies to use that to invest in people and assets and growth. But you do want to make sure that a company doesn't have that that EBIT, da of like 10 over the long term, that would be really, really problematic. Yeah, it would.

Dave

26:47

And I think the bottom line is we have to think about every business that we're investing in, we're investing in not only the business and and, and what it does and what it sells and the services, but you're also investing in the people that run the business. And many times, the captain of the ship, the CEO is the one making those decisions. And these numbers can help give you I guess, a guide of maybe how well that Captain drives the ship. And sometimes, just because they're the CEO doesn't mean that they're the right fit for that particular company.

And so that's something that you can kind of keep in mind as well when you're looking through this because capital allocation is job number one for every CEO. And when you think about the the elite of elite of CEOs, insert name, Buffett Munger, Jeff Bezos, just on and on and on, all those people were fantastic capital allocators. And the people, the businesses that struggle the ones with nobody remembers the names of the people that ran the companies that have gone out of business, except maybe the gentleman from Enron, because he was interesting individual, I'll just keep it that. But I think, you know, beyond just the liquidity part of it, that's something else that you could kind of look at as a way of, of measuring management, which is an

important part of the process. But solvency and liquidity are, as Andrew said, are vital to long term investment success with any company. All right, well, with that, we will go ahead and wrap up our conversation for today.

Thank you guys for listening, I know that we probably throw a lot of jargon at you. And like Andrew said at the beginning, there are some terminology in here that may be a little confusing, maybe a little overwhelming. We have a solution for you, we have an answer to help you with this investing for beginners.com, our website, big huge search bar at the top of the page, type in net debt to EBITDA.

And you will find lots of fantastic articles about that very subject. If you are confused about current ratio, or current assets versus current liabilities, we have articles about all those things. So it's a great resource to help you learn more about the terminology that we're throwing out there. Because not only are you learning from listening to us, but you can also learn from reading from some of the stuff that we've created for you to help you learn all this stuff because it can be overwhelming. But just like anything else, the more you use it, the more familiar you're going to get with it and the easier it's going to be and once you understand the general concepts of something like current ratio, you'll never forget it. So without any further ado, I'm gonna 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.

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