Episode 56: Fundamental Analysis is Fundamentally Flawed

Bob French 00:00
The purpose of Retire with Style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to risaprofile.com/style and sign up to take the industry's first financial personality tool for retirement planning. Have you ever spared a thought for all those poor hard working market analysts making the markets better for long term investors everywhere? No. Well, it's still pretty funny to think about. Hey, everyone, welcome to Retire with Style. I'm Bob French. I've fully taken over this show at this point. I've got my guests, Wade, and Alex here with me today. So say hi, everyone.

Alex Murguia 01:09
Hi, everyone

Bob French 01:10
There we go. That's right. But today, we wanted to get into some of the some of the more interesting things around kind of the different types of analysis out there. So, you know, previously, we've talked about how the markets work, or kind of what the markets are, I should say. We talked about some stuff that very, very clearly does not work. Technical analysis. So if you don't like that, I guess, well, sorry. It doesn't work. But now, we're going to dive in and start talking about something that works in a way that the people doing it don't want it to work. So we're going to start talking about fundamental analysis.

Alex Murguia 01:56
Hey, Wade, sorry sorry Bob. But did you notice something here today? This is Bob's sort of intro we gave him we gave him a shot right? What have you noticed that's your review? Please, please write your reviews on Apple etc, etc. It is what it is.

Wade Pfau 02:21
Very, very straightforward. Here's what we're gonna talk about. None of the chitchat let's get

Bob French 02:27
This is a straight five paragraph essay type of show. So

Alex Murguia 02:32
this is Bob's type five although Bob you forgot to mention that you did not see you have not seen the Godfather from the previous

Bob French 02:45
I have not and to be clear it's clearly out of spite, so

Alex Murguia 02:50
okay, well, I'll just my last one before we get into the down and dirty here. So you have two girls I do. Wade, you have a beautiful girl as well? Correct? I do. Yes. Okay, so I have all boys so there it is. But this is I want to I want to talk about challenge you on that. It's before my time. I couldn't see the movie or whatever. i What, what quote. Well, what song is 16 going on 17 from? What song is that? I am remember The Sound of Music Bob sound? No, Wade, no, that's 1965 Yeah, sound of music. You've got it. I thought for sure. You know,

Bob French 03:46
I haven't told you the story yet. But this past weekend, I took my my older daughter to the bookstore. And she saw the the novel of The Godfather. And she she asked me about that. Hey, isn't that this famous movie? And I had to explain to her yeah, it absolutely is. It's supposed to be like the best movie ever made. I have never seen it and I will never see that because Alex really cares that I watched that so obviously it's never gonna happen. So

Alex Murguia 04:15
So Wade, Wade, what I want to know is why am I living in Bob's head rent free?

Wade Pfau 04:22
Hey, Bob, I saw this streaming on Peacock

Bob French 04:29
Wade was talking about how efficient and you know straight to the point we are. Alex is still gotten in his his couple minutes and chit chat on the front end somehow. So

Alex Murguia 04:41
No, I'm trying I'm trying to humanize you

Bob French 04:43
I think it's more Alex's influence on the show, but

Alex Murguia 04:47
Well and so it goes. But honestly, you tell you have seen the sound of music.

Bob French 04:52
I've seen the sound of music. Yes.

Alex Murguia 04:54
Oh, Wade, Wade.

Wade Pfau 04:56
Oh, yeah, yeah, I've seen it but I was probably eight years old and I don't remember it.

Alex Murguia 05:00

Oh, that's the last time you see, you'd haven't seen it with your daughter?

Bob French 05:03
No, I don't think my daughter's have seen it either.

Alex Murguia 05:06
Really? Oh, wow, I was referencing it thinking that oh, you got to show that one too. You got to show that one to them. So great movie. Alright, enough, enough fundamental analysis action.

Bob French 05:26
Yeah. So I think a good place to start is, you know, I mentioned we, we've done a couple episodes up to this point. But, you know, one thing looking back, that I really want to make sure we touch on is, you know, something actually pretty fundamental to how we think about the value of a security. You know, we're always talking about like stock price or bond price or but stock price is here to talk about. You know, we're talking about as this as if it's the single thing. And, you know, one of the things I really want to drive home is that there's this idea, or there's markets need to clear, every share of Facebook is owned by someone or excuse me, every share of meta is owned by someone, there's no wild shares of meta roaming Lower Manhattan, every share is owned. And the market needs to find the price where that happens, the market needs to find that price, where someone is willing to own every share. Now, that's not to say that shares, prices are perfect. Let's just say that, yeah, they're pretty good. And you know, price moves based on that new information. But every share is owned. And that's a really, really crucial point, that bid and ask the price that someone's willing to buy or sell the security at, they need to converge, they need to find that level. And I think that's a really, really crucial point, especially as we start talking about kind of fundamental analysis, which is when someone's gonna go in, I'm sorry, Alex, go ahead.

Alex Murguia 07:14
With that statement, every share needs to be owned. And so is it fair to say if you already own the share? Right, and you refuse to sell it at, at the, at the at the bid and, you know, you're you're, you're still owning it, you know, you think the price is different, you're kind of setting the price at that point

Bob French 07:38
If I own Facebook, and you know, the someone's willing to pay me $90, but I think it's really worth $100 I'm still going to own that chair, I'm not willing to take that $90 So that's, that's still cool. You know, if I'm someone who's looking to, to buy Facebook, or if I think that Facebook is worth $90, but someone's willing to sell it to me at 100. I'm not gonna buy that. Well, what the market is trying to do is find the balance, where you know what, that's about even where everyone oh, we're all of those shares are owned by someone who is happy with the price that they're holding that security at.

Alex Murguia 08:27
Yeah, and if someone's happy

Wade Pfau 08:28
with D and economics, this is supply and demand.

Bob French 08:31
This is the point where the lines cross

Wade Pfau 08:36
Yes, the quantity supplied has to be equal to the quantity demanded, and the price adjusts to the point where the quantity supplied the people selling at that particular price matches the people willing to buy at that price. And then that's the equilibrium and that fluctuates, daily basis as

Bob French 08:54
So that's a much, much more eloquent way of describing that. So,

Alex Murguia 08:59
So, so Wade then based on Yes. Last week's podcast on technical analysis, this is you sort of saying technical analysis works. Because the main tenant, the first tenant wants to find demand, or

Wade Pfau 09:12
Yeah, that was the first time it wasn't, I think what we determined was the first three tenants make a lot of sense. And maybe that leads you into a false sense of security. Because the fourth tenant took you in a completely different direction of now you can suddenly predict what's going to happen in the future based on past fluctuations.

Alex Murguia 09:32
Perfect.

Bob French 09:33
So yeah, I wanted to call that out. Because with fundamental analysis, this is the one with all the accounting stuff. You know, as we talked about last time, technical analysis is all the pretty charts. And you don't need to worry about the the hard accounting stuff. Fundamental analysis is the hard accounting stuff with all of the ugly spreadsheets, where you go in and either for an internal stock, an asset class As an index the market as a whole, you try and figure out, Okay, how much should it be worth how much, you know, I'm gonna go out and predict all of Amazon's cash flows for the next 30 years. And you know, when the stock price is the, you know, when you really come down to it, you know, thinking about it from the the dividend discount model, the stock price of any stock is the discounted value of all of its future dividends, how much money you're gonna get out of it? Well, I'm gonna model that out, I'm gonna model all this stuff out and come up with the price that I think Amazon is truly worth. You know, there's, there's a lot going into that statement. But that's, that's the basic idea. You try and model out a company or the market or whatever it happens to be, and figure out, here's the correct value. And, you know, if the market is valid, is saying, it's worth more than that, well, I'm going to sell that stock. If I can get a discount on that. If I think Amazon's worth, I have no clue what the Amazon stock price is, right? Now, if I think Amazon was worth $120 a share. And you know, it's trading at 100, we'll shoot I'm gonna go in and buy up as much Amazon as I possibly can, because I'm getting a discount on that. And I think the market will be coming up to meet. You know, what I think Amazon is worth. There's a whole lot of assumptions in there, which we'll we'll talk about in a little bit.

But one of the really interesting things here is that I think fundamental analysis is a lot more interesting than technical analysis. We haven't been shy about our opinion on technical analysis. But fundamental analysis actually is doing something really, really important. In the market, it actually does work in a certain way. There's a lot of value in what fundamental analysis is doing. The problem is, what they're really doing is they're offering a service to the market as a whole. They're not necessarily the one or that they're not the ones reaping the value of their work. It's the market as a whole. It's all of us, especially us being kind of passive index type investors. We're piggybacking off of all of the work that they're doing, getting those prices right. You know, they're effectively the the altruists of the market, which is a really weird thing to think about all those people, you know, Goldman and on Wall Street. Those are those are altruists, they're doing us a favor. They're doing all of our work for free.

Alex Murguia 12:58
Wade. Did you catch that? The altruism Word of the week. Yeah, no, but that's a it's a very, very, very good point, Bob, when you say that, and I want to make sure people know, they're not. They're not benefiting consumers? Because Oh, I can read the research reports. And that's a buy when they want, you know, at that price or that No, no, that's not what he means. Bob, in case you were thinking that, that they're providing some sort of research that everyone can piggyback off of? No, you're he's speaking about it from a price discovery perspective. They're kind of fighting each other to figure out the right price. They're trying to, they're trying to set the price where and that allows consumers to just effectively be price takers, price takers, and just accept the price as is. Because these guys, have you thought about it enough that it's kind of, you know, becomes a best estimate.

Bob French 14:01
Exactly. Exactly. It's we're able to sit back and just kind of let them do all the hard work of doing all of this modeling, and figuring out where where should that price converge to? Where should that equilibrium price on Amazon or Cisco or GE or you know, pick your stock? Where should that be? And, you know, they actually do a relatively good job of it, actually. Which is what allows index funds and passive investing as a whole to work as well as it did. If there were no I mean, this actually gets back to that idea of, you know, when is there too much indexing? That's actually possible. If everyone in the world was a passive investors, or passive investor, it wouldn't work, because there's no price discovery mechanism at that point there. is no way for prices to move to the correct level. Now, the problem is that we essentially have an overabundance of fundamental analysis analysts, we have so many people trying to do this and trying to beat each other, the market is, the marginal value of that last person doing fundamental analysis is negative, you know, they're not adding value, they're actually subtracting value at that point from from themselves. So, you know, that I want to be very clear here, the market needs fundamental fundamental analysis to work. It's just, you as an individual, you don't need to pay for it.

Alex Murguia 15:48
Yeah, the irony of ironies here is that if you're an active manager, charging somebody, I don't know, whatever it is, one and a quarter or whatnot, for to invest with them. And if you're a passive investor, that's, you know, complete point of separation from that person, the passive investor is actually benefiting more active manager, then the actual investor into one of his or her funds. Yeah, that's, that's effectively what, what Bob is saying, because, you know, let them duke it out. And you could make the cut, and we're not getting into it right now. But if you look at the results consistently from active

managers, they they underperform, so there there is no benefit, but in aggregate, having them duke it out, it kind of benefits us and what Bob is saying, from the vantage point that yes, if everyone was a passive investor, there would be a capital would be inefficiently allocated because no one is discovering in the discovery piece. But we can comfortably say that the markets are efficiently inefficient. For you know, for a while, it what that number is I don't know about but but know what that line of demarcation is doesn't matter. Because it'll, it'll like, flip back very fast.

Bob French 17:16
Exactly that's one of the beauties of the financial markets, they're self correcting mechanisms, if too many people start indexing, if too many people just start being passive? Well, those fundamental analysts, they're going to start outperforming, you know, they're actually going to be there's going to be few enough of them doing it that they're going to be providing actual value, which means people are going to see those higher returns and flood back over there, to try and capture those returns. And it's just gonna be that cycle back and forth. Now, the problem, like I said, is, we are so far past that point, with so many people trying to predict what price levels should be trying to beat the market, that were a little more than a little out of whack, even with kind of the rise of passive and index type investing. But that, fundamentally, is what's going on here.

Wade Pfau 18:18
And so there is an element of free writing, to some extent with passive investors. But at the end of the day, like when I first started learning about investing, I kind of realized that my comparative advantage in the world is not going to be to pick the individual companies to invest in, I'm not good with the balance sheets and being the fundamental analyst. But if I can not spend my time trying to pick individual companies, that just frees up time to do other things. And that's where like, anyone who's been part of retirement researcher knows, we're not giving, telling which individual companies to invest in it. There's all these other aspects of financial planning and tax planning and, and everything that goes alongside that, that if you, you can focus your efforts on other aspects of financial planning. And, to some extent, piggyback off the fact that we do need some people doing that fundamental analysis, and they are being compensated for it, because they are charging fees for the work that they do. And that's where none of those fees, it can be hard for an investor to benefit from investing directly in those active managers. But that at the end of the day, there is some sort of balance there. And like you're saying, we don't need everyone in the world, we need some people doing fundamental analysis, but as an individual yourself whether or not you want to engage in that fundamental analysis, partly depends on do you enjoy it? Is it a hobby for you? Do you kind of you may recognize at the end of the day, you might not have a better investing outcome. But if you feel better doing the fundamental analysis yourself, there's there's no problem with technical analysis. We'd say you're you're wasting your time ultimately, but with fundamental analysis, it is useful and important and if you enjoy it more power to you. It's just not everyone in the world needs to be doing fundamental analysis.

Alex Murguia 20:06
Yeah, no, well, but But Wade, yeah, you can do it. But you, I don't think you're saying the second part of that sentence, which is you most likely will not be successful at it.

Wade Pfau 20:14

Yeah. And you may not have a better investing outcome. But you're not necessarily creating harm in the same manner that you would be if you devoted all your efforts to the technical analysis, you may still underperform the market just because at the margin, you may not be getting a better outcome from your fundamental analysis. But at least it is providing this.

Bob French 20:36
So I think you should just be clear, you know, as an individual, if you're doing fundamental analysis, once again, thank you, you know, the value you're providing is to the market as a whole rather than yourself. But the market, but there are so many other people out there doing fundamental analysis, that the marginal value you should be expecting to receive, again, is zero to negative. And that's even before considering the time that you're spending. So as Wade said, if you just think it's fun, and, you know, knowing, knowing some people who listen to this, I'm sure there are some people who, you know, they have fun with spreadsheet hour every night. They are fun. But you know, it just to be clear here, the marginal value on that, that next. That next fundamental analysis is nothing, it's just not there. Let's take a moment to let the audience know that this show is sponsored by retirement researcher. You can learn more about retirement researcher at retirement researcher.com And subscribe to our newsletter, where You'll receive weekly actionable information for your retirement planning benefit. Retirement researcher is an online community devoted to helping you create the retirement income plan geared towards your goals.

Alex Murguia 22:03
I think you guys are hedging here a little bit. I would say like if you think it's fun, become a bookkeeper, or something like that. No, seriously? No, because we use this for our own copy, like McLean and Retirement Researcher and Risa yes, we, we do figure it out, like net present values and things like that, right. But as an investor, I think you should treat it like, you know, picking stocks or whatever. And this is where we made the supermarket comment a while ago, and yes, it's not 100% solid analogy, but like, when you go buy milk, I don't buy milk, and I look at the milk carton and say, Oh, it's whatever. 250 Yes, you know, I just buy it. You know, assuming there's a budget constraints, you just buy whatever you need, and you move on with your day. You don't you don't worry about what was the price of chips today? You know, that kind of thing? Yeah, this is like, I'm getting away from budgeting, I'm having a conversation, just the dynamic of when you go to the store, you accept the price for what it is, right? You don't you don't necessarily. Yeah, exactly. That's exactly correct. And, to me, that's, you know, I mean, I can hedge but um, you know, I can be the bad guy, which is become a bookkeeper, you know, you know, galleys, get paid for it, you know, by somebody, and then, you know, take up Sudoku or whatever. And then, and then think about buying stocks, like when you go to the grocery store, you just you accept the price for what they are, you know, and I was gonna get into that that whole member sync film, Bob, when he would get into fundamental analysts, then capitalist then, you know, he would draw upon high IQ in terms of look in the capitalism, right? Yeah, assets flow efficiently. And you accept that, because there's a good allocation of capital, the only people that don't feel that are people that, you know, try to really engineer economies, if you will, right, you know, because capital capital is not efficiently allocated, right. And so that that would mean that there's miss pricings everywhere. Because as an aggregate as an aggregate as a whole, we've mispriced securities, right, which is an inefficient use of capital, if you will. And you know, the story, you know, Seinfeld goes on and does his thing. I'm not gonna do it as good as him or anything along those lines. But effectively, when you get right down

to it, the only folks that consistently believe that assets are mis allocated and things aren't priced the way they are, are people that construct economies, you know, they're really engineering and fundamental analysts to a large extent.

Bob French 24:54
And so I'll just be clear what you're saying fundamental analysts are communists, just to be very clear.

Alex Murguia 25:00
Well no, no, no, but you wanted to get to the frontline

Bob French 25:04
This is first time I've ever been been accused of being insufficiently harsh on, on active management. But But Alex is absolutely right here that, you know, it's if you think you can out predict the market, or come up with a better price or a more true price for, you know, pick a company, you know, that means that you are saying you're smarter than the aggregate of of everyone out there of all of the other people trying to figure this thing out. And maybe that's true. And but you got to have some pretty strong evidence of that. So yeah, but I think what might be good here is to actually walk through an example of what fundamental analysts are actually doing here, because we're talking very, very high level, you know, fundamental philosophies of how economics works here. Apparently, when they're bringing out high IQ and all this type of stuff.

Alex Murguia 26:08
Well, nobody goes to the whole technical analysis, like silliness, where, what's the anchor here? What's the anchor to this?

Bob French 26:15
Absolutely. But okay, so let's, let's pick Amazon, I actually just took a look at the price it's called, we're recording this a little while ago. So hopefully, nothing super major has happened, but it's trading around $100. Market cap is around a trillion dollars. Now, let's say I go through, I run the numbers. So I go out, I forecast all their cash flows, I look at all the business lines. So you know, amazon.com, the biggest store in the world. You know, AWS all of the Web Services stuff. I don't know all of the other ancillary businesses that they run, they've got their fingers in, like, everything's I know, there's no way of me doing all this, I tried their

Alex Murguia 27:02
ad business is going crazy, just FYI

Bob French 27:05
So I try and predict all of the cash flows. Now, first off, let's recognize just how big of a challenge just that in and of itself is, you know, when we, you know, when we look at the cash flows of our sister company, McLean, you know, a financial advisor, one of the simplest kind of businesses to kind of model out. It's really free and hard. It's, it's really hard to kind of figure that out. Now, expand that out to like the largest one of the largest companies and most complex companies in the world. I'm trying to do this out through time. But I do, I come up with the numbers, I think is right. And I think the company is

worth 900 billion, I think the market is over pricing. Amazon, I think it's worth less than what the market is charging for. So instead of $100 per share, I think it'd be a call it $90 A share. Well, you know, I'm gonna go out and try. And if I own Amazon, I don't want to be holding that $100 a share, I want to sell that as fast as I can. I want to capture that $10 per share of value, or as close to it as I possibly can. So I'm gonna go out in the market and just dump all of the shares die out. And, well, one of the again, we talked about how the market is a self correcting mechanism with regards to the number of fundamental analysts, to me, it's also self correcting in terms of price discovery, it's going to that's going to tell the market, the price should be lower. And, you know, me personally, if I was to go sell however much Amazon I happen to own, I have no clue at all ethna a big signal. I'm not moving the market a lot. But it does contribute to the information out there. It's saying that I think that is worth less. And enough signals like that, you know, that's going to move that equilibrium point two that Wade was talking about there, that's going to pull it down. If on the other hand, I thought it was worth, you know, 1.1 trillion, I thought the share price should be $110. Well, I'm gonna go out there and buy as much Amazon as I possibly can. And that's going to push the price up. And, you know, theoretically, if I had, effectively unlimited money, I'd keep doing that until it got to the price that I think Amazon is worth. That's the basics. That's what's going on here.

Alex Murguia 29:46
Bob,is it fair to say I'd like that one caveat, because I'm just trying to think when we say the average investor, the average investor, and there could be a listener. Well, I'm sure they are right, that they're saying to themselves else? Well, the average IQ is 100. I know that I'm a good one, one and a half standard deviation above that, because whatever, you know, I'm in Mensa or whatever they're, like, cut off his right. So I'm at 130 two standard deviations, just like, there you go your two standard deviations over. So I am going to play in this game, because I do know more than the average market participant. I, you know, the flaw there to me is like, everyone's everyone's vote isn't equally weighted, etc, etc. And it just depends on a couple of discoveries, you know, to be done to sort of set that. But is there something for you to add on that? How you would counter that, that that person say no, but I'm, I'm smarter than the average market participant?

Bob French 30:46
Yeah, absolutely. That, you know, it's not the Think of it as the weighted average participant. And even more than that, you know, the dollar weighted average participant, so, you know, you going in, you know, let's say you got $10 million to play with, so you do, you're doing real well, for yourself, you got $10 million to play with. That's not even a drop in the bucket. You know, we're talking about, you know, a truly massive, massive system, you know, full of people who are also really, really smart, trying to figure this stuff out. This is not, you're not competing against retail investors. You're not competing against financial advisors, you're not competing against us. You're competing against the big institutional players, those are the people who are truly driving the market now. Say what you will there about a lot of those people, apparently, they're they're altruists, as we said, but they're also incredibly smart themselves, they have access to incredible amounts of information, and incredible tools to process that information. Even more importantly, you know, we all have access to largely the same information set, you know, we got access to all the annual reports, we can go by Bloomberg, you know, we got all this stuff we can get to. But we don't have the tools to process it as efficiently as fast as some

of these other kind of more institutional type players in the market. And that's who we're going to be competing against.

Alex Murguia 32:32
But, well, I would say, though, that in the previous episode, we said that, yeah, there's institutional money, but even in aggregate, that can be dwarfed. I would also say to add to that, it's an add on, uh, but I would say, there because of the market dynamics, and how the price discovery were there, and this is not going to quote Dan Wheeler, who we talked about in the last episode, but you know, rest in peace. Effectively, they're, they're fishing in an empty lake. The dynamics are such that you're playing a game, you really can't win, because of everyone, because everyone is participating in it in a certain manner.

Bob French 33:16
Yeah, no, exactly.

Alex Murguia 33:19
It's nothing to do with intelligence. There's, there's a lot of money in money. So there's a lot of smart people there. But that's not that's not the case.

Wade Pfau 33:28
And it's not the you're not competing against the average investor, you're competing against the aggregate beliefs of all investors. And you had to somehow have an insight that all other investors in aggregate did not have

Alex Murguia 33:44
100% I just wanted to address the whole the average investor No, but um, you know, the average investor, hell, you know, the average IQ is 100. So I take a random investor, I know I can beat him, you know, that kind of, I just wanted to kind of just Yeah,

Bob French 33:57
I think it's worth kind of also talking about some of the assumptions that you're making, in terms of when we're talking about trying to beat the market using fundamental analysis. The first is, you're coming up with the correct price, which is a heroic assumption in and of itself, that you can truly value this where everyone else can't. But it's worth pointing out, that's useless in and of itself. So the market is trading Amazon at $100. But, you know, it really should be at one time. Okay. Great, you know, something that no one else knows. But unless something changes, that doesn't mean anything. The second assumption is that the market will then realize your genius and come up to or come down to the level that you think Amazon should be at. So the market for this to be at all useful. Them market has to agree with you, or the aggregate of the market has to agree with you and push Amazon up to $110. That's how you make your money by buying it down when Amazon was trading at $100, and everyone else agreeing with you, and coming up. Now, it's interesting to know that both technical analysis and fundamental analysis are making a pretty big assumption that the market is rational, just with a lack, they're saying the market is going to be rational just on my timestamp or timeframe, it's going to wait for

me to figure this out before it moves to, you know, whatever the new price is supposed to be. That's a little bit egotistical there.

Alex Murguia 35:47
Yeah, it's like that, quote, The futures already here, it's just not evenly distributed. And you're constantly on the front end of that distribution.

Bob French 35:56
So I mean, those two assumptions there, that one you're gonna get, you're gonna be able to figure this out better than everyone else, really big in and of itself, but sure, will, will grant that for right now. But you've also got to make the assumption that everyone else or enough other people will come to the same conclusion that you did fast enough for it to matter. Because, you know, obviously, all these things are moving around, meaning the true price is going to move around as well. So the market needs to come to that slow enough for you to be the first or one of the first people to come to that conclusion. But fast enough, that, you know, it's still meaningful, fast enough that that true price is still useful. You're threading a pretty fine needle there, basically. You know, so it's always worth calling that out.

Alex Murguia 36:50
Yeah, and what were that mentioning, and it may be beyond the scope of this podcast, because we could go on and on is the assumptions to derive at that price. Because you're just saying in one sentence, you get to a price. But if you really do it and this bob said it very early then sense of look our own companies McLean, I can't tell you what our earnings are going to be at the end of the year, I really can't, you know, and think about that, right. And then you have Amazon a trillion dollar company, that analysts get it down to the penny. That's a game. It's just a game. I don't know, again, they're backing into a number. But let's say you're now doing this yourself. And you're gonna, you know, to do this analysis, there's present value calculations that you have to take into account, which which assume a discount rate. And the discount rate is based on the risk free rate, which is, you know, think about the conversations that Wade and I and Bob, to some extent, have had over the last 50 episodes about market assumptions. And the flaws in capital market assumptions and the best estimates of capital market assumptions for financial planning will multiply that by 100, if not more, when you're taking Amazon into account. And not only do you have to be right on what the quote unquote present value is, based on all these macroeconomic factors, so you take the right discount, but then it has to, it has to manifest itself before you go bankrupt before you know you're consistently theoretically right. But in practical terms, it was the

Bob French 38:26
Keynes quote, the market can stay irrational longer than you can stay solvent. So

Alex Murguia 38:31
Yeah, exactly. Liquid Yeah, who was a terrible investor by the way? No, no, not Keynes. I'm sorry. I was thinking of. Apple guy. Yeah, the Apple guy. Jesus. Oh, my goodness. They're gonna kick us off the podcast. Isaac this is this isn't Isaac Newton, Isaac Newton. Thank you. Oh, smartest guy ever

actually right it man like the DaVinci. God Isaac Newton remember, like, but that was more behavioral finance thing? Who like he like, lost everything. I think in the East India thing.

Bob French 39:19
I don't know if it was everything. But yeah. So in that, in that whole bubble, and he got, he got wiped, pretty hard.

Alex Murguia 39:28
Yeah. But going back to it's not a matter of intelligence that you know, the full circle here is it's not a matter of intelligence. You're not smarter than him. No one is.

Bob French 39:38
Yeah, no, absolutely. That's a really great example. I mean, it's obviously wasn't quite developed. And actually, this is a good entree. Well, first off, also call out. You're getting it complexity for calculating a lot of stuff. I actually have a workshop in the academy, the retirement researcher Academy, talking about a lot of these investment mistakes and we get into calculating MBV and you know all these fun things, or at least I think they're fun. But you know, if you really want to dive into that, that's, that's something you can take a look at there. But I wanted to talk about, there's a couple different approaches, there's a lot of different approaches, but two kind of big kind of categories of approaches to fundamental analysis. So there's the Graham and Dodd Type value investors, who are looking for kind of big Miss pricings, at the kind of company level. You know, they they talked about value investing, it's very different from kind of the academic value investing the value premium type of stuff we talked about. And then there are people who are just looking for just straight up mispricings, price arbitrage type of stuff. So let's, let's start with kind of looking at the Graham and Dodd folks first. And when you look like you're trying

Wade Pfau 41:02
That would be be the more modern, yes, we're gonna be the more modern. Yeah, Graham,

Bob French 41:08
and the guys who wrote the book, literally wrote the book on it. But yeah, there's a lot of people who are doing it. And Buffett is probably the most famous kind of, I'm not sure a proponent is the right word, since he's out there telling everyone just go buy index funds. But the most famous practitioner, I guess, you could say.

Wade Pfau 41:29
So the idea there are fundamental analysts to compete with. Yeah, exactly. Another another is trying to push that

Bob French 41:35
easy guy push over there. But you know, what they're really doing is they're looking at the companies from an intrinsic value. So looking at the accounting values, and looking at the moats and all these different types of things. And they are systematically doing the pricing models on all of these companies, these are the people who will have like, five stocks, they're really, really sure about, and

that will be their portfolio. And to them, that's a great diversified portfolio, because they're really, really confident in their calls about these five or 10 companies or whatever small, arbitrary type a number I'm going to throw out there. And, you know, they're going to wait for the market to come to them effectively. So,

Alex Murguia 42:27
Bob the only caveat I would add, Bob, I would add this caveat, I think it's important. We're dealing it from value investors that are like, spreadsheet warriors right now. Yeah, you know, but they're our group. And you could throw Buffett in the mix, there are a group of investors that do more than just, you know, find an undervalued security, but then they're actively participating in that. And even vulture investors and things like that, and I don't I don't, I don't think I you know, from a spreadsheet valuation standpoint, yes. You know, I agree with you, but I wouldn't put like, the vulture guys or the the activist or those folks in this mix just yet.

Bob French 43:10
Okay. Is that Yeah, no. And, you know, Buffett, actually, he's a good example of those activists. You know, there's a lot of people out there talking about him who, you know, he's not really an investor, he's really just a manager, you know, he goes in and buys a stock, he's buying enough of that company, that he gets to go in, and effectively, he's the CEO, or he's the person who gets to make the final call for that company and guide that company into doing whatever it is that he thinks is best. Whereas URI if we're doing this, you know, we're probably not going to be be able to put ourselves in that position. We're just going to be kind of I own .0005% of this company, you know, the the CEO ain't going to be taking our call. Are you getting close to or are you in retirement? Well, investing during retirement is a little bit different than during your working years. Your investments are there to help you pay for retirement. And now is when they need to earn their keep to make sure you're on the right track, download Retirement Researchers eight tips to becoming a retirement income investor by heading over to retirementresearcher.com/8tips again, get Retirement Researchers eight tips becoming a retirement income investor by going to retirementresearcher.com/8tips. That's the number 8 tips.

Alex Murguia 44:41
Yeah, but that's that's all I want. I didn't want to take it too far off because that's another kind of thing you know, if you will, and we can do a private equity thing at some point, but it's really more I just wanted to get the sense because I'm thinking people are listening. And and there's more to Buffett than just Oh, identifying a lower price and and that's it. You know, there's more to Carl Icahn, there's more to, I don't know, there's always a new a new

Bob French 45:04
Almost any of them you can name were probably more in that type of category unless you're really dive in deep. So, but yeah, no, absolutely, that's a really, really important point that those people are not price takers. You know, there are people who are actually influencing these companies. So what, but again, getting back to kind of the Graham and Dodd value investor, you know, there are people who are trying to match up that intrinsic value, or find the difference in that intrinsic value, I should say, from what the markets doing, and then waiting for the market to come to them. It's a very, very systematic type of approach. That, you know, again, really adds a lot to the market as a whole, even if it's not as

much them. The other type are people who are looking for I more of the arbitrage type of approaches, they're looking for a kind of those quick hits, in terms of differences, you know, they'll do kind of big, broad scope analysis, and look for peep, for those stocks that are just slightly different wait for the quick turnover, and kind of go at it from from that angle. So it's really a question of kind of slightly longer term with kind of that value investing type of framework versus the arbitrage quicker type of turnover type of stuff there. So that's a really important distinction. But what you want to be thinking about is what type of information are these people really bringing to bear? You know, we've talked about how valuable it is, because they're bringing in all this information, they're doing this price discovery for us. What does that what are they actually doing? And a lot of people kind of think, is just, they're sitting down with a five foot pile of annual reports, and just running the numbers. And, yeah, okay, they do that. But that's only part of the analysis, you know, what they're really doing is, they're bringing in all of the available information. So they're looking at those annual reports, they're looking at balance sheets, they're looking at income statements, but they're also incorporating, what do you think the markets going to look like? How's the economy going to change over the next year? Five years? 10 years, 30 years? How are people going to react to that? How are people going to react to that reaction? All the way down the line? It's kind of the I came problem here. You know, I know that you know, that. I know that, you know, and having to model all of that out and incorporate that into your model. It's, it's hard. It's it's a lot of uncertainty. And at a certain point, you know, there's a ton of information there. But at a certain point, you kind of making a guess a little bit.

Alex Murguia 48:02
Yeah, and look we're not bringing up individual data right now, on investors, because you could, you could be asking yourself while listening to this, so yeah, but there's some people that are successful.

Bob French 48:13
We'll talk about that next week

Alex Murguia 48:14
We'll get to that we'll get to because it's all it's almost like sports, you know, frankly, but we'll get through it. We're laying down. If you picked up from this pocket, we're just laying down the theoretical underpinnings because if you understand it at this level, and it makes sense. It's kind of good enough to certain to a certain extent, because the numbers will you know, you'll see how they follow. If it doesn't ever make sense, and we show you numbers, then it's not as strong.

Bob French 48:46
Yeah, the numbers are, you know, yeah, we could go there. But if you don't, the basic argument, or if you don't agree with us on the basic argument, we're not going to agree on what the numbers mean.

Alex Murguia 48:59
Yeah, exactly. 100%. I can't tell you how many times we can show you numbers over and over about look at the performance. Isn't that but you'll still do your? Yeah, but kind of thing. Yeah. So this is our 10.

Bob French 49:12

Yeah. And so I mean, that's kind of the the big thing here that the fundamental analysts are the ones who make the market operate efficiently. They're the ones who allow the efficient market hypothesis to actually work, ironically, by trying to break the efficient market hypothesis and beat the market. But again, this gets back to the financial markets being just incredibly powerful self correcting machinery in that, you know, when someone outperforms well, everyone does that. And that brings it back down into back down in the line.

Alex Murguia 49:54
Let me let me introduce something here because I gotta again, assume that some people are thinking this. You were throwing the word efficient market efficiency around now? I think it's the first time. The first time we did it today. Right? And so it's an interesting concept. But let me, let me actually bring weight in since he's the the trained economist. I just, I don't even play one on a podcast, I just feel around, right? Wade, what what, you know, market efficiency? How would you say it from a textbook perspective?

Wade Pfau 50:29
It's the idea, that's really been the underpinning of what we've been talking about that everyone's trying to outperform the market now, setting the passive investors aside who are freeriding of the others. But a, everyone's trying to outperform the market. And so the given market price incorporates all the available information that if some people if enough, people thought the price was undervalued, they buy it today. And that would push the price up today. If enough people thought the price was overvalued, they'd sell it today. And that would push down the price today. And so the price today in the efficient market hypothesis is just the collective wisdom of everyone in the market, trying to guess what the market is going to do, leading to an equilibrium between that supply and demand that the current price we see is the price that incorporates all available information, such that will the price go up or down tomorrow is going to depend purely on the news that comes in, that's going to be random with respect to whatever people were expecting that if if if it like a great example is a company could have record earnings, and the price would still go down, because the market expectation was that the earnings would have been even higher. So whatever news comes is ultimately random with respect to nobody in the market knew what that was going to be. And that's how you see the price changes. And so you can't really predict future price movements, because the efficient market ideas, all available information is incorporated into the current price of the security. Okay.

Alex Murguia 52:14
Then I would ask, I'm gonna play a little bit of a devil's advocate here, because this is where people kind of like start saying, Aha, I got you, you know, that kind of thing. All right, Bob. So and I thought we'd just to add to that, I thought you were gonna go into the perfect form semi strong form, you know, that kind of CFA definition, definition of thing. But this, okay. I want to make point, the point clear, this does not mean, prices are perfectly priced at all, you know, let's get that out of the way. Because this is where people can say, Come on, don't don't give me that that prices are priced perfectly. Look at GameStop we refer to it the other day, right? This does not mean that prices are it does not need to happen that prices are perfectly price. So Bob, what would you say? If someone said Yeah, but look, Schiller just want the Nobel Prize with family even, you know, of all things right? Talking about how prices aren't rational. So I'm bringing now the concept of rational prices aren't rational. And so we can

catch those moments of irrationality, which, you know, the volatility on the markets are such that prices aren't perfectly priced, it can't be.

Bob French 53:29
Yeah, I'll say, a couple things. The Nobel Prize Committee, they hedged real hard on that prize, they gave it to a couple of level basically for saying every part of finance that was basically the creation of finance Nobel Prize. So fama was saying,

Alex Murguia 53:40
So it was a technical analysis, it was,

Bob French 53:48
But so a couple of things there. One, I would also point out, you know, Schiller, Taylor, all of these guys saying, hey, there are problems in the market. They're in suggestion for 99% of investors go by an index, just just go by the market. Don't worry about it. You know, this doesn't have that much of an effect end of the day for for truly long term investors. So there's, there's absolutely that piece there, in that, you know, what do you do with that? Yeah, not a huge amount, or at least you can ignore that over very long term time periods. The other thing I'll call out is the market is everyone kind of recognize that the market is going to do weird stuff. That's just gonna happen because there are people involved, we're not perfectly rational, all that type of stuff. But getting back to your main point that prices aren't perfect. That's a really, really important idea. You know, that's often kind of the soundbite that you hear about the efficient market that says the markets perfect It's not even pharma will come out and say, Yeah, prices aren't perfect. The catches, there's a buck there, that but is that we don't know, we know prices are wrong. But we don't know if they're wrong because they're too high, or they're too low. And at that point when we can't, when we can say they're wrong, but we don't know which direction they're wrong, we kind of just have to accept that. We kind of just have to start from where they are now and say, Okay, that's my best guess. And that's all anyone's ever really going to say about price. These are the best guess, given all of the available information and all weighed your you can probably hear Wade stressing that all in his definition. That all is all that is all encompassing everything you can possibly imagine, gets funneled into those prices, you know, the the Super Bowl score is somewhere in there, probably not moving at that much, but it's in there. And everything else as well.

Alex Murguia 56:07
The only thing I would say to that, and I think we can, we can do this when we talk about like market timing, because I want to point out I'm going off of one phrase that you said that we don't know if it's overvalued or undervalued, I think at the securities level, I subscribe to that. But could you say at the .com Boom, during the boom, hey, there's a bubble here. So if anything, it's overpriced. I'm not I'm not arguing. I'm just, I don't want to discuss it even right now. We will do this when we get to market because we're there's a conversation to five minute mark right now. Yeah, exactly. And we'll spare everyone until we can. But But I will say this from from my definition of market efficiency. You know, if you integrate what Wade said, and you integrate what Bob said, where I land is effectively I don't care if markets are overpriced or underpriced, you know, the best estimate is what we see, you know, and your your most efficient, just taking it like going back to the milk example. Right. But more importantly, I truly feel it's efficient in this sense, Wade, and Bob can't can't, Wade and Bob, if weighed myself and

Bob, I have access to the same information that's available. I am not going to consistently and I'm using the word specific, I am not going to consistently outperform Bob, I am not going to consistently outperform Wade and vice versa. You know, we have access to the same information, the markets are efficiently priced in the sense that we're not going to outperform each other, you know, based on some extra insight, based on some extra neurons that I have popping because my IQ is five points greater or less than either one of them. No, it just it doesn't happen like that. And that's where I land on this market efficiency in terms of I'm not, you know, you know, if we have access to the same information, I'm not going to outperform persistently anyone, because in aggregate, it's just how it is.

Bob French 58:06
Yeah, I mean, that's at the end of the day, that's really what it comes down to, you know, what do you split? What should you be doing with your own money? Well, I mean, unless you are basically if you are in a position to be able to consistently outperform the market. You ain't listening to this podcast. You're on your private island somewhere with your trillions of dollars because that is incredibly valuable. It's also incredibly rare. And we'll talk about that in a couple of weeks about how we can how we know we can make that statement but that's exactly right. What do you what do you do with your money? Well, yeah, just kind of take the market and that's your best bet.

Alex Murguia 58:54
Wade

Wade Pfau 58:54
Ready to wrap it up. Yep. Yeah. All right, everyone, okay. Yeah, this is gonna be a lengthy episode but thanks, everyone for for joining and we'll catch you next week as we continue it is the the next week's episode will be on market timing right.

Alex Murguia 59:14
The perfect timing, no pun intended. All right. Take care everyone.

Bob French 59:17
Wade and Alex are both principals in McLean Asset Management and Retirement Researcher. Both are SEC registered investment advisors located in Tyson's Virginia. The opinions expressed in this program are for general informational and educational purposes only and are not intended to provide specific advice or recommendations for any individual or on any specific securities. To determine which investments may be appropriate for you, consult your financial advisor. All investing comes with the risk including risk of loss. Past performance does not guarantee future results.