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Hello and welcome to this week's Dividend Cafe recording here from the Newport Beach Studio, where I am excited to talk to you today about value investing and in a way talk about value investing by talking about growth investing, unpack some of the things that are happening right now that I believe reflect some real concerns in many investors' mentality.

The goal out of today's talk will be to reinforce very time tested principles and do so with a little bit of a more recent history overview that I think will be useful in us understanding risk and reward in the context. Of these terms of value and growth. I don't believe that investors have fully walked away from caring about value, putting it a little differently, caring about valuation, but I do believe that they're caring about it right now in a, shall we say, flawed way.

So let me unpack it a little. I don't do this a lot in the Dividend Cafe, but I'm going to do it today and not worry at all about anyone who might be bothered by it. Many people know the listening to Dividend Cafe, I happen to be a man of faith and a professing Christian, but I don't quote a lot bible verses in Dividend Cafe, although maybe I should do it more. This verse I quote today though, as real application to the topic at hand. I remember my late father preaching about this 'cause it's a funny verse but in Proverbs chapter 20, verse 14, it says it's no good, says the buyer. And then the buyer goes off and boast about the purchase and there's this kind of comedic reflection of someone saying, oh boy, this is a pretty bad deal.

I guess I'll do it. And then they turn around and be like, yeah, there's a great deal. And I think it reflects that even, many thousands of years ago, there's always been an embedded understanding that. A transaction often has to be good at the time of purchase. There, I'm not sure I fully agree with the cliche that money is always made at the buy, but I certainly believe that buying something cheaper indicates a better opportunity than buying something more expensive.

Now, this is basic, tology as they say, or at least as I say, and yet. There are things that ought to be intuitive to us that what you pay for something matters. And I think it's surreal that we even have to have this conversation when it comes to investing. That buying at an attractive price is a good thing.

Yet the fact of the matter is that we do have to say it because there has become a school of thought. The important thing when you get an investment is that it feel good when you are buying it, not that you believe it's going to feel good later, and I think it's very backwards. The fact of the matter is it's not always supposed to feel good at the time you buy it.

That in fact, the various distress. Or headwinds or concern about something that makes it attractively valued is itself the opportunity and that it doesn't feel like it at the time. And like our funny merchant in the proverb, he may say this is no good, but then really is excited for what the future opportunity could go.

Even though we can't say that at the point of a transaction. We are in a state of modern era investing in which. The point of investing for many people is to take something that's already up a thousand percent that is already very popular, and be able to go brag about the fact that, Hey, I just bought this big thing that every single person you could possibly talk to believes is a hot investment.

And that doesn't mean it can't get hotter. And in fact, some of the most popular and well-known ones have indeed done just that. It does speak to the fact that our comfort zone is now gone from the Proverbs 20:14 idea to the opposite. Let's brag about it, not feel like, oh boy, I can't believe I'm doing this.

And then not. The opportunity is more embedded in it must certainly go higher. Now, first of all there is a kind of implicit greater fool theory in a lot of it that I don't think people consciously think through. Which is if they were to recognize this investment is already pricing in a lot of the great opportunity that exists in the fundamentals of the company what their excitement would have to be is that they just simply believe there's somebody else out there who will pay even more for what is already priced in that great opportunity.

And that can work out just fine, but it isn't really a future looking notion. What I believe is important to say is that there are a few things that can happen when one is buying an investment that already has very great prospects, that there is already an expectation of tremendous growth that's reflected in this thing we call valuation and I believe it'll be important for us today to walk through those outcomes to get an idea of why I feel the way I do about this topic.

My bias towards value oriented investing comes from the study of the, some of the greatest investors we've ever seen. The buffets and grams and ackman's and tes and icons of the world. That the notion of something being uncomfortable at the time I purchase increases, expected rate of return and so I just would like to see more people churn on its head the notion.

That unpopular is bad and already popular is good. It's ought to be counterintuitive to us, but in fact it's become very conventional. The interesting piece about this is people might look at the momentum growth world and just say what could really go wrong? And it's funny if you bought to let's just say the Nasdaq, the end of 2021, and you go, it's up so much.

But you're up a whopping five, five and a half percent per year because it then drew down a bunch and then it had a really good ‘23 and ‘24, and it's competed around this year way down, but then back up a bit, not back to high, but nevertheless recovered. But from the beginning point to end point in that little period it's a very subpar return actually, but not down.

And, I do talk a lot about the lessons from 2000. Where the Nasdaq did drop meaningfully about 78%. And it took 15 years to recover. So there, there is a risk just in the nature of what drawdowns might be. But there's, but even apart from the violent downside, like that prior example.

There's also a possibility of just more muted growth when you buy something very overpriced that even if it does okay and muddles through, you end up later on just saying, wow, it was up 20 here, but down 20, there were all said and done. It really wasn't up all that much. I don't think people are thinking of it that way, and I think an awful lot of growth investors.

Very candidly have never seen any sizable type of downside. So they haven't ever felt the need to check what their real worldview is on investing, what their actual thesis of the case is. And I'm hoping that will cause people to do that here today. So let's say you have a company that has already gone up a thousand percent.

It's been very successful, it's really doing well, and there's big expectations for the future. It is not my view that any company already up a thousand percent can't go up more. In fact, it's my view that the generational success stories are going to do just that. And there are a million past examples and there will be plenty more future examples.

But let's just look at from that point of time when a company's already gone up a bunch. Now you enter it at that time. The question then becomes what's gonna happen from here? And if a company does very well. And has great returns 'cause they've done very well. And so then the optimism for the future really increases and that valuation goes way up.

Then going forward, the company could exceed even that optimistic expectation and that's likely gonna create a very good outcome for the investor. Even if you buy it after initial great returns. And even if you buy it after the valuation, reflects optimism for the future, including huge optimism for the future.

If it exceeds those optimistic expectations, that's a great outcome. So that's on the table. But then another thing that could happen is that exact same chain of events and evaluation goes up and there's high optimism for the future. And it doesn't exceed that optimistic expectation, but it meets it there.

You're gonna get a suboptimal outcome, may not be catastrophic. The operating performance was good, but the investor returns will actually be muted because the person who sold to you after the optimistic valuation increase, they captured all the premium. You paid them for the premium of the future, and then it just stayed level it met, but didn't exceed what had been priced in for the future.

And then the third is very common, and unfortunately, the real bad one. Which is if a company does very well, great ex returns are experienced because of how well it did, there's then big optimism for the future. It boost up valuation, but then it underperforms that optimistic expectation and that can lead to catastrophic outcome for investor, both because of difficult operating performance and the valuation.

Now if we were just using kind of examples. These types of companies. The first scenario I described, you could think of your apples and Googles over the last 20 years. The second you could think of like a Cisco in 1999. It absolutely met expectations, but it didn't exceed those wild expectations. The expectations were so high, it ended up being very subpar back in the day.

Elise, it's certainly done much better last 10 years. Then like a Peloton out of the COVID moment would be an example of just a ridiculously optimistic valuation for the future, not being able to come close to meeting it. And then obviously a bloodbath for investors. Just, I'm putting a few names around the potential scenarios you could connect this with, but what is all three have in common is that the valuation was the operative variable at play.

Not necessarily the price and not necessarily the results. The operating performance in the second outcome was very good, but the investor results were poor because of valuation. The price was already high in the first outcome, but the investor results were still very good because the operating performance exceeded the valuation.

Obviously the double bad of the third scenario was both high valuation and poor operating performance, leading to the worst possible outcome. Price matters to the extent that it reflects valuation that is either good or bad. The price is not predictive or causative, and even operating performance.

This is the whole point of Benjamin Graham's intrinsic value investing. Operating performance matters to the extent that it is above or below a valuation. What Graham's valuation model that was largely replicated by Warren Buffett was that you discounted future cash flows to a net present value and that value.

Might be higher than the current stock price, meaning the stock was at a discount to its intrinsic value, or it could be at a premium, meaning the value was already reflected and then some. If a company grows at 25% and it's expected to grow at 40, that's not a good investment. If a company grows at 7% when it was expected to grow at 4%, that could be a very good investment.

This is what I basically mean about valuation being so important. This is why the relevance of what is going on at the time of purchase matters. Most people are gonna be more excited to go to the bar on Friday night and brag about buying an investment that's gonna grow 25 or 30% a year going forward than they would be to brag about a company that's gonna grow six or 7%.

Those two data points don't tell you future expected results because they have to be taken in the context of what expectations for future growth were measured in valuation. I hope this all makes sense so far, but here's the issue. Everybody knows that valuation matters in every single thing we do. We do not say.

You know what? I really love steak, and so it just doesn't matter what I pay because I'm gonna like the steak anyways. So yes, I will go spend a thousand dollars for the steak. We rather take our taste and our appetites and our preferences and various risk reward trade offs if we're thinking about a business decision or a hiring decision.

When we do economic calculation, almost in real time, we're instantaneously doing some form of valuation. This is the essence of economic thinking and economic activity. It reflects the thinking of valuation. Now obviously there are some things that are just awful and you go, I don't want to do this awful thing at any price.

But there are plenty of things that are not awful that you do wanna do, but you don't want to do a certain price. Scarcity can drive some of our freedom around this, but so can our own cost benefits analysis. So it's very easy for a steak lover like me to use the steak example because I'm in a position I can afford a very expensive steak, and I really love steak and whatever.

I pay for a steak, I'm going to like it, and yet I'm not gonna pay a astronomical price because of the just basic, intuitive reality of value assessment. Why would we think this becomes any different when it gets to investing? We do it in day-to-day business decisions. We do it in day-to-day consumer decisions, and of course we ought to be doing it in asset price decisions as well.

Now look, I think that there is a supply demand reality here that unfortunately becomes a complicated, there is only so many shares available of X, Y, Z, hot stock, and. You basically will have investors that just want to buy the hot stock no matter what. And whether it's a shiny object, whatever.

It could be a very good company. It couldn't be a, not a shiny object. It could be not a Peloton 2020 situation. It could be a growing company, but then the valuation gets, it ought to temper the appetite for it because the, attractiveness of the investment is measured by that supply demand reality.

And what I mean by this is that you don't want your own fomo, fear of missing out to get in the way of what you know to be a reasonable price. And when something is hot and successful and popular, and there's only a certain amount of shares available, that's bidding the price up and it would be hot and attractive and successful for everyone.

If it just stated a level valuation and then had the operating results that you rightly believe were gonna happen, 'cause we'll just assume you were gonna be right about that. The valuation is the thing that is going to temper the attractiveness or lack thereof of the investment. And I would argue that too many times it is not tempering that x, y, Z is good regardless of whether it is 20 times, 40 times, or 80 times earnings.

And this leads. To some very difficult outcomes. The irony in a lot of this, and this is something I've learned over the years from a really great investor by the name of Richard Bernstein, is that we believe growth investing is rooted to this great optimism for the future. There's just gonna be such great growth.

There's such innovation we don't have to worry about. We're paying for it because I have a optimistic view of what's gonna happen into the future, but in a lot of ways. That's actually very backwards. I think value investing is making an optimistic view of the future. There's a whole lot of companies that are gonna do well and therefore I can be selective in the price I pay, I'm gonna get a better return by me being more selective in what I pay.

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Growth says I have a pessimistic view of the future. There's not gonna be that much growth in the future. So I gotta overpay for where there is good growth. So you look at the three or four, or shall we say mag seven most popular names. I gotta overpay for those names 'cause God knows nothing else is gonna do well.

Now I'm not saying everyone thinks that, and I'm not saying everyone that very many people think it consciously or explicitly, but I do very much believe that's the implicit rationale. For high priced growth investing versus value investing? I think value investing is actually contains a much more optimistic view of the future.

It gives you a permission structure to be valuation sensitive 'cause you think there's a whole lot of ability out there. To improve results, to do good things, to have talented management, to innovate, produce, profits. And yet you say, I want to, in that ecosystem be selective and in growth you're saying, I can't afford to, I gotta just go get my hands on the most expensive things I can because nothing else is gonna grow adequately.

And I would really encourage people to think through that a bit. The idea that we're in a moment I preface this whole Dividend Cafe by saying people over care about value again. And the idea is, look, the growth stuff's done so well, what are we gonna do? The funny thing is that if you look at when the new century new millennium began, it was over 20 years until growth had caught up to value.

That the returns coming into this new century new millennium, starting in the year 2000. We were past 2020, past COVID before growth caught up to value. There are extensive periods where things can go the other way. Now, what was the issue? That caused that, because that's in a period where, yes, the first decade was obviously a very bad decade for growth, but the FANG period from 2010 to 2020 was the golden years of growth.

What is the reason that value actually outperformed growth for over 20 years? And the answer is entirely the valuation at the beginning point. You could say you're cherry picking the timeline, but that's the whole point. You have to cherry pick the timeline to make the point of what hypothetically can happen at a given point of entry, and we're at a given point of entry right now.

The, I mentioned the NASDAQ went on 15 year period, a subpar performance, and by subpar mean underwater didn't recover its initial level until 15 years later. But that was not that peak level in NASDAQ that then crashed, was not catalyzed by any specific event. There was not a war, there was not a recession, there was not a major macroeconomic event or company failure.

It obviously was not even catalyzed by a change of outlook or prospect for the internet itself. The, we did not go back to a dial up modem world. We did not reject e-commerce. If anything, I would argue the web outperformed what were very robust expectations for what it would mean to our way of life.

Now, when I say that the internet outperformed, I certainly recognize that a whole bunch of companies that were caught up in it at that moment proved to be the failures that they were. But the Nasdaq breaking in 2000 was not merely about. 25-year-old party kids running dot com's, billion dollar valuations, and they had no revenues.

There were actual incredible companies that powered the internet and powered our country's technology ecosystem. That broke as well. And what catalyzed that was not event driven. It was a bubble that burst. And this is the issue is bubbles are often not recognizable. Until after they've burst.

Now, I don't believe what Al Greenspan once said, that you never know you're in a bubble until after it's burst. I think you can know something's a bubble. I think it was painfully obvious that.com was a bubble in the late 1990s, and I think it was painfully obvious that housing was in a bubble in 2005.

But what I mean is you don't know in identifying something as a bubble how much more the bubble can blow. Before it burst, and this is the really difficult thing that speaks to a character. It certainly speaks to an intelligence, but it speaks to a metal. For value investors, a resilience, a grit that I think is at the core of what makes one a good investor and certainly is something that I take extremely seriously as a professional investor and feel reasonably proud at this need.

How I wanted to cultivate this in my own investing habits as a fiduciary over the years, you have to hold that medal, when you believe that things are in a bubble and the bubble is going bigger and bigger, and the temptation for many investors to join, the fear of missing out crowd in those moments is absolutely overwhelming.

But that ability to re to resist the seduction of that moment is extremely important. And yet I'm gonna talk more about bubbles. In a couple weeks in the Dividend Cafe what we're dealing with right now in the growth moment. I would argue it may be that eventually what PO calls an end to this party is a valuation burst, which is what it was in March of 2000.

But there's also fundamental catalyst that could not, that will, but that could surface. I do not know that the US will hold a monopoly on artificial intelligence. I think it's entirely possible they will. I think the threat of deep seek could mean that they're not going to, and I think that could prove to be a deep fake and forgive me for absurd joke.

But I think it's entirely possible that we got away with a really US-centric. Ownership of the smartphone sy ecosystem of, in a lot of ways the internet and the building out of what the web would become. And we may not hold that on ai, but maybe we will. I think it's entirely possible that some of the big successful tech companies face a regulatory apparatus that has not been fully appreciated.

DOJ concerns, I thought that the DOJs case against Microsoft in the late nineties, going in the early two thousands. Was perversely stupid and eventually it Microsoft prevailed and it didn't break the internet or break technology. It didn't help Microsoft a lot at the time. But right now you can look at various antitrust accusations and bundling accusations and business model issues, and they're gonna be favorable or unfavorable political regimes around it.

There's various possibilities, but not assurances of risks entering the fray on some of these things. So again, a more event driven catalyst that exists. I've talked a lot about the AI CapEx, perhaps all of a sudden slowing. Again, it may not, but that no one can say that the risk is zero. And of course I've also talked not only about CapEx declining, but the people who are the customers of AI CapEx wishing it had declined in the future.

Because we find out on the other end of this that the ROI, they expected just simply doesn't materialize. It doesn't materialize in the timeline they wanted or in the way they wanted, or even maybe at all. Now, in every case I just brought up and I could list out a lot more possible scenarios. I don't know that I'd put anywhere near a 50% probability on any of them.

What I do know is every one of them is a probability higher than zero, and so there is the possibility of an event catalyst leading to pain and suffering for this growth space. And then if there isn't, there's the rather, I would say high probability of valuation incident becoming real. But my conclusion of the matter is that these things are being dismissed because right now, today.

We know is these investments just got done doing very well for the last three or five or 10 years. And I'm not buying for future opportunity. I'm buying 'cause today, which is another way of saying in the immediate rear view mirror, it, it feels comfortable. And this is the distinction between value and what they refer to as growth.

I do not know when high valuation companies are gonna hit a peak. I don't know what the correction will be like when they do. What I do know is that the mentality ought to change. Now if the mentality were to change to anything cheap, the cheaper, the better, is going to do well there is another risk.

The other side of that, which is what we refer to as a value trap, where sometimes things have gotten really cheap 'cause they're headed to extinction. It's pretty rare. It's not something I've really run into a bunch, but it could definitely happen. And I think avoiding view of growth that is overly romanticized, that make, makes one valuation agnostic to their own peril.

And then on the other side of the coin, avoiding a value trapped that says this thing is so cheap that it doesn't matter what happens is also very dangerous. Where I think investors want to be is in the space that no longer believes the lie. That value is opposed to growth. What we want to see are companies that we think we're paying a reasonable, if not attractive entry point for.

While getting growth in the business that is measurable and empirical and objective to us. 'cause the growth is reflected in a growing dividend that is not exactly the same way people talk about growth when you talk about growing valuation, growing PE ratios, et cetera. But the application of received profits, dividends is a subset of a value and growth mentality.

Okay. And I think that there is no value where there is no growth, but that the value comes in the price you are paying for future growth. And yes, some growth is bigger than others, but the whole entire conversation hinges on the fact that some valuations are bigger than others too. Thank you for listening.

Thank you for reading. Thank you for watching the Dividend Cafe. Brian Szytel will be with you in the Monday Dividend Cafe. I'll be outta the country for a few days with my family, and I'll be back with you next Friday. Thanks again. Have a wonderful weekend.