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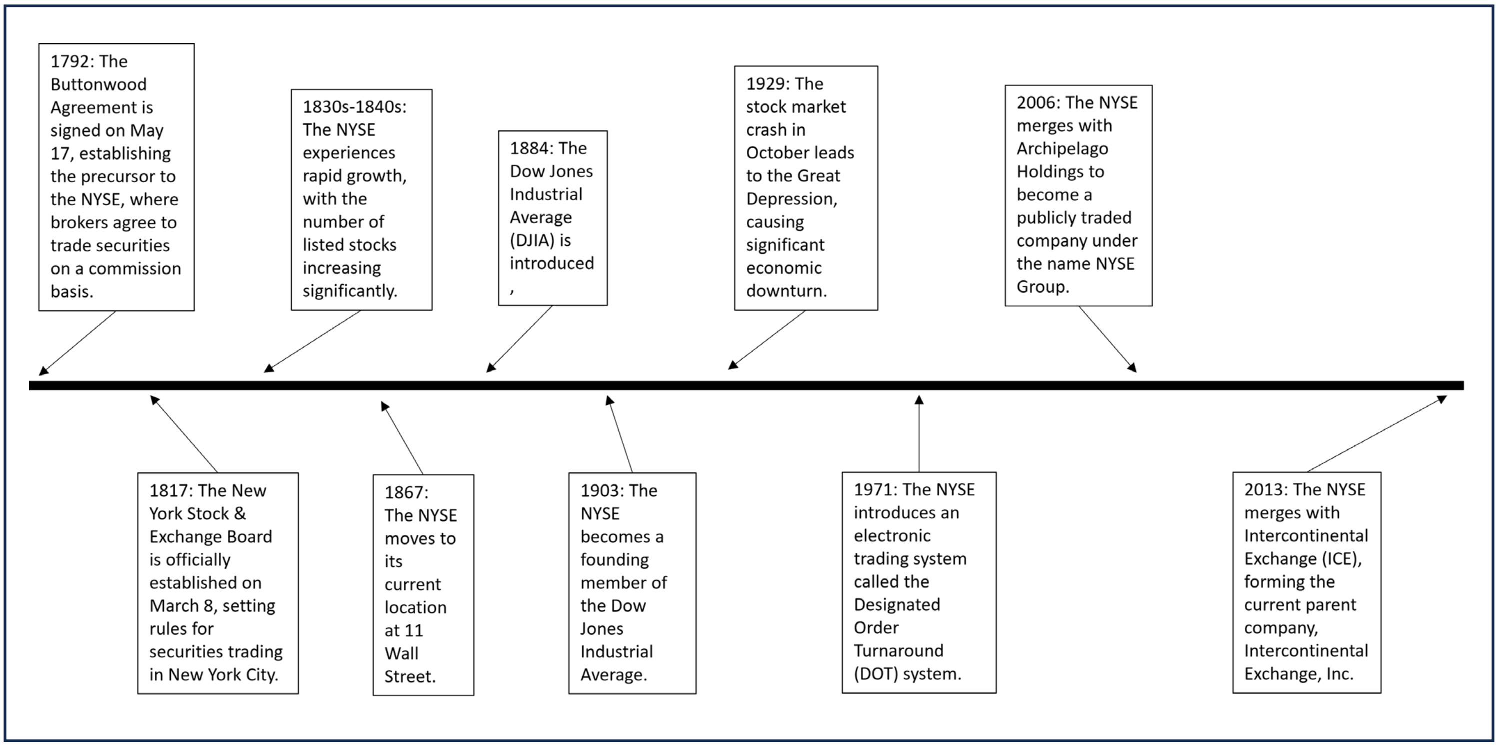
Adulting the Stock Market

Introduction

With the New York Stock Exchange's founding in 1792, US companies in need of fresh capital could meet investors in a formal setting governed by rules and regulations. In today's world, every major stock exchange offers a reliable mechanism for investors at all levels to build and modify their investment portfolios.

History of the New York Stock Exchange



Cautionary Note: smaller stock exchanges can be completely unregulated or even rigged. These should always be approached with caution and deep skepticism, or avoided altogether.

How Does A Stock Market Work?

Let's start from the beginning – we own a successful company seeking more money to grow its already strong business. Where can our company find that money? Generally, there are two paths we can follow:

1. Borrowing money from friends, family or a lender like a bank; or
2. Selling some of our ownership to new investors who will share the risk and rewards with us.

When we offer to sell some of our ownership, we mean we are selling shares of stock in our company's ownership (every corporation must issue shares of stock to establish who owns what.) Let's say our company has 1,000,000 shares of stock, of which 900,000 shares are already owned by us. Now, we want to sell the remaining 100,000 shares to raise more money to grow faster. What is the fair price? How is it established? How is it regulated?

Valuations

When a stock price is quoted in the market, the entire business is being revalued in that moment. As the price continues to move, it reflects investors expressing their opinions on the fair value for that company; and opinions vary.

When it comes to how we find the fair price in any moment, there is a well-established *rule-of-thumb* the market has used for many decades – a mature, low growth company is worth about 5-7 times it's operating cash flow (that means the profits the company makes before things that do not relate to running the business, like taxes and interest expense on debt.) The rule comes from an observation that owning the stock of any business is riskier than US Government bonds or an FDIC insured saving account – the higher the risk, the more return we must demand to put our money at risk.

In other words, valuation is simply forecasting a company's future operating profits to justify today's stock price – the catch is the horribly complex forecasting process when no one really knows what will happen years down the road.

That's why it's not be surprising to find very highly valued tech companies (risky) trading at 50 or even 100 times its current operating cash flow because the growth rates are thought to be extremely high. For these tech companies, both the stock price and the risk can be sky high at any moment as opposed to slower, more old-fashioned businesses.

Valuation and Regulation

As you might imagine, when we talk about the future, things get murky very quickly and that's where manipulation or even fraud can take root.

For example, what if a company or someone looking to sell their stock position forecasts crazy profits? Well, every company as well as existing shareholders can be held liable for any such statement. Moreover, an existing shareholder issuing such statements can be forced to back them with concrete actions like our example, below.

Twitter Becomes X

Most of us know Elon Musk bought Twitter and changed it to X. What many missed is that Elon starting goosing the Twitter stock price by threatening to buy the entire company. At one point, he even made a formal offer at a price assuming lots of continuing growth. At the same time, Twitter management recognized Elon's bid was way too high, accepted his too generous offer, and took him to court to enforce the offer.

Once Elon realized his mistake, he tried to back out, but many investors had already traded based on his offer, which was also regulated by US laws. Elon was correctly forced to buy Twitter at a crazy price because one cannot pump a stock's price only to dump it soon after at the now higher price.

That concern over pumping and dumping is only one of the many shenanigans market regulators seek to stop. While regulators try, they cannot completely stop all the bad stuff, which makes the stock market far more treacherous for amateurs than it should be in our opinion.

How do we know this is true? Well, over the last 50 years the S&P 500 index (a broad measure of the US stock market) has returned an average of 10.5% (1972 to 2022.) But we know from above that even mature companies are generally priced to return 16-20% a year. What is happening? Some of it is overspeculation, and some is gaming the system.

We accept some level of gaming is inevitable despite having the best regulated markets in the world. You cannot police everything which also makes the market a treacherous place for amateurs wanting to pit their smarts against the professionals. The deck is too stacked against amateurs in that fight and it's usually a slaughter by the end.

While regulation helps to keep valuations more realistic, it cannot fully combat that other tidal force – overspeculation.

Valuation and Speculation

By now, you should get that valuation is almost the entire game; and it has many related issues we need to understand to *adult* the market properly. As we noted above, over the last 50 years, the S&P 500 has returned a not spectacular 10.5% when we consider that fuddy duddy companies should give us around 18% each year when valued properly. This long-term underperformance mostly reflects the impact of overspeculation, or holding to a theory without firm evidence.

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When we try to forecast a company's profits more than a year out, we must speculate. How deeply we speculate depends on the nature of the business and how far out we have to go to justify today's stock price. Let's look at three examples:

1. Sempra Energy
   a. A regulated utility who cannot raise most prices without regulator consent.
   b. Annual revenues have grown at 10% annual rate over the last 5 years
   c. Stock price has appreciated 43% over the last 10 years (4.3% per year)

2. NVIDIA
   a. The leading AI chip manufacturer
   b. Annual revenues have grown at 39% annual rate over the last 5 years
   c. Stock price has appreciated 17,234% over the last 10 years (1,723% per year)
3. Trump Media
   a. Social media platform that came public via a SPAC (Special Purpose Acquisition Company)
   b. No 5-year revenue track record
   c. Stock price declined 50% since going public this year.

Each of these companies engages in very different businesses and has been public for varying lengths of time. Both NVIDIA and Sempra have long track records investors can analyze for guidance over complete business cycles while Trump Media offers very little data.

The following table sets out the valuation differences and degree of speculation in the price, or having to make big guesses about the future to justify todays price:

Company	**Stock Ticker**	**Value Multiple[1]**	**Degree of Speculation[2]**
Sempra Energy	SRE	13.82	19%
NVIDIA	NVDA	59.55[3]	88%[3]
Trump Media	DJT	Infinity	100%

1 – The company's total value (equity value plus debt) divided by operating cash flow, or how many years current income is needed to reach today's stock price. To calculate this number, we multiple the current stock price by the existing number of shares and add any debt the company used to grow (also called a company's Enterprise Value.)
2 – For each year after the first year, we add 1.5% of uncertainty for simplicity.

3 - Although uncertainty grows very quickly each additional year, so are NVIDIA's forecast cash flows accelerating, too. In the end, these factors basically cancel each other for our Degree of Speculation score.

We can see from the table that we should have the most confidence in Sempra's future cash flow while NVIDIA and Trump are highly speculative values today. We can understand NVIDIA's risk because it makes profits and has a 25-year trading record; Trump Media, however, has only a couple of years' experience, less than $5 million in total revenues, tens of millions in annual expense and Donald Trump holding the majority of the stock. In fact, DJT is so speculative, we would assign a score above 100% if possible because companies like this should never be public at this stage of its development.

Despite our feelings about very highly speculative stocks, you can find hundreds of them. Most trade on the "over-the-counter" market, also known as the "Pink Sheets." Generally, these sorts of stocks should be avoided although there are very good exceptions like Slate Grocery REIT, a Canadian stock we can only buy through the Pink Sheets. Finally, there are also zombie stocks listed on major exchanges like the NASDAQ that should also be avoided because they make no profits and the road to success remains murky – the very definition of overspeculation.

To understand better why actual stock market returns over time have underperformed what investors would have expected, we asked our favorite finance AI engine, Hey Pi!:

> "Eventually, reality often catches up with speculation, leading to a correction or bear market that can result in significant losses for investors. While it's difficult to quantify the exact degree to which overspeculation has contributed to the underperformance of the S&P 500 over the past 50 years, it's likely that it has played a role in some market cycles.
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> "For example, during the dot-com bubble of the late 1990s, many tech stocks became highly overvalued as investors became overly optimistic about the growth prospects of the internet. When the bubble burst in 2000, many of these stocks experienced significant declines, and the broader market also experienced a correction.
>
> "Similarly, during the housing bubble of the mid-2000s, speculation in the real estate market led to inflated home prices and risky lending practices. When the bubble burst in 2008, it contributed to a broader market sell-off and a severe economic recession."

How we deal with speculation and frothy valuations will materially impact our returns over time. The more we limit speculative purchases, the less risk we take for our overall returns – a fact many investors fail to adjust for when looking at performance. In other words, if you had to take a lot of risk or a little to get a 10% return, which should we always prefer?

Let's consider at a practical example – you have to cross a fast-moving river. For $1, you can walk across the nicely paved footbridge, or for $0.25 you can rent an inner tube with a paddle. Which would you take? Your answer may reveal what sort of investor you really are. In case you do not already know, we always take the footbridge.

In the end, speculation collects its toll. Even when we buy a low speculation stock like Sempra Energy, we can see there are many outside variables that will impact the value we receive, including changing demand for electricity, new regulations, competition, world events like wars and people's perceptions about the future. We cannot know them today, so we take some risk in exchange for expected profits high enough to entice us to buy.

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Risk and Returns

We can see how swirling winds move valuations all over the place and we know there are very sharp traders looking to slice a piece from our trades, so why is the stock market a good place for responsible investing again?

While we've criticized the S&P 500's return over the last 50 years, when you compare it to other investments, you can see why *adulting* the stock market is a better place to be:

Total Investment Returns 1972-2022

Investment Type	Total Return	Note
FDIC Savings Account	5.0%	
Treasury Bonds	7.0%	
Gold	7.5%	Also add an annual cost to store
Directly Owning Rental Residential Real Estate	9.0%	Varies greatly by location
Directly Owning Commercial Real Estate	9.0%	Varies by location and industry
S&P 500 Stock Index	10.5%	Includes dividends
Stock Market REITs (Real Estate Investment Trusts)	11.5%	Includes dividends

Sources: FDIC, US Treasury Dep't, London Bullion Market Association, National Council of Real Estate Investment Fiduciaries (NCREIF), Dow Jones Indices, and National Association of Real Estate Investment Trusts (NAREIT).

While there are risks and problems investing through the stock market, it still beats most things over time when we invest like adults.

What does *adulting* the stock market really mean? It means we avoid most big speculation investments, that's where investors are eventually clipped more often than low risk companies. There are some fuddy duddy stinkers, too, but the high volume of tech losers swamps disasters in the old-fashioned side of the market. Here's a little more from Hey Pi! On the subject:

> "Over the past 50 years, there have been periods when both speculative tech stocks and old economy steady stocks have outperformed each other. However, on average, old economy steady stocks have tended to provide more consistent and stable returns over the long term."

For every Microsoft and NVIDIA, there are too many Pets.com and Netscape corpses that went to zero. That's a lot of death and destruction, in corporate terms.

Conclusions

Approaching the stock market responsibly means we:

1- Minimize big speculations on stocks that require many years of profits to justify its stock price today;
2- Buy businesses that profit share with in dividends – when we get money back, we further reduce our risk;
3- Diversify over different businesses to minimize problems in one investment hurting us too much;
4- Find professionals we trust at a reasonable cost, or buy index and money market funds if we do it ourselves;
5- Find valuations on stocks where our confidence is highest; and
6- Patience is a virtue – letting our positions grow organically over time works.