The Australian Finance Podcast Episode Transcript

Episode: Why does the stock market go up? | Ft. Brian Feroldi
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Speakers: Kate Campbell, Owen Rask & Brian Feroldi
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Episode transcript:

Owen:
Kate, welcome to this episode of The Australian Finance Podcast.

Kate:
It is wonderful to be back Owen.

Owen:
Yes, it is. We're recording at 5:00 AM. Because we have a very, very special guest with us today. Brian Feroldi, how are you going there?

Brian:
Doing great because it's not 5:00 AM or I am so I'm nice and chipper.

Owen:
What time is it?

Brian:
It's 3 o'clock in the afternoon where I am.

Owen:
Perfect time to record a podcast mate and tells all that in your book to keep things off, we were thinking, how did you start learning about investing and which resources did you use when you were approaching the stock market?

Brian:
Sure. So, I graduated from college in 2004 and I graduated with a degree in business. Now you might think that I was naturally to taught a lot about investing in the stock market and money given that I was a business major, nope. I graduated from college with zero essentially next to zero education about money, about investing about the stock market, about 401(k)s, about all the things that are incredibly important information for people to learn how to build wealth over long periods of time. But when I graduated, my dad handed me a copy of a book that was very popular at the time called Rich Dad Poor Dad by Robert Kiyosaki. That book was at the pinnacle of its importance in society and I read it cover to cover in two days. It was the first time that I had read a book that talked about some of the most basic concepts about wealth and wealth building and how the rich think about money differently than everybody else.

Brian:
And while I have gripes with that book today, and I don't necessarily agree with everything that it talks about, it was the first time that I heard things like, "Everybody is in business from themselves, the rich use their money to buy assets. The poor use their money to buy liabilities. Anybody can become wealthy in one generation, you can use the tax code to your advantage." And all of those concepts just completely blew my mind. They were the very first time that I'd heard about them before and for whatever reason, those concepts were just extremely appealing to me, my personality. So, I just latched onto them immediately and that just kicked off a never ending binge of me really consuming financial content. So, I've read tonnes of books, I've listened to podcast, I've joined newsletters, I've been on forums and everything that's related to money, personal finance and investing, I have just soaked up and absorbed.

Kate:
Yeah. And I know that Rich Dad Poor Dad has been that sparking point for many people in our community. We have a similar book well, it's a bit different in Australia called The Barefoot Investor, which millions of people have read and really changed their life based of it. And it's amazing what one book can do for a large population of people. Yeah. And given how long you've been investing for much longer than Owen and I believe from what I've seen online, despite you don't look it, I wanted to ask you about some of those periods of investing through challenging times, such as the dotcom crash and the '08 market crash. Because a lot of us and our listeners in our community haven't actually invested through any of those times. So, it's cool to learn from experiences of people like yourself who've been through it.

Brian:
Yeah. So, I started investing in 2004. That was when I had a job and was able to like put money in the markets. I can tell you that I remember the dotcom crash of 2000 and 2001, specifically 2001, because like everybody else in the world, I was glued to my TV on September 11, 2001.

And I saw everything that was going on with the terrorist attacks and I vividly remember the next couple of days, once the markets reopened, how everything was just straight down, everything was just red. And I remember reading in the paper again, I didn't pay much attention to the market, but I knew it was bad. I knew that it was just horrible, what was happening and at the time I had no clue what the Dow Jones Industrial Average was, what the New York Stock Exchange was, what the Nasdaq, I had no clue what any of those terms meant.

Brian:
But I did know it was bad when they were going down. And I remember thinking at the time like, "Well, that's it, capitalism had a good run. This whole stock thing, I think it worked out for a while, but it over right. Look how bad it's doing now." And spoiler alert, it came back and it was fully recovered essentially by the time I started investing in 2004. So, like I said, I was very into investing, very interested in learning, I was starting to put capital into the market and really learn about investing from 2004 until 2008. And that's when the great recession hit the United States and I vividly remember numerous times putting capital, a lot of capital into the market at that time, my income had gone up significantly, we didn't have any kids at the time, so our savings rate was very high.

Brian:
And every time I put money in the market, it like immediately fell to 20%. It was I bought again and it was like the next day, "Boy was at a terrible decision." It felt so awful to be doing this and putting money in and I'd be, "Great now I'm buying at lower prices." And then it would immediately go down and, "Great I'm buying at lower prices." And immediately went down and this happened over and over, over and over again for a period of months. But one thing I think I did right, is that I knew that over long periods of time, the stock market went up. I don't think I fully understood why that was, but I did feel that I was buying it better, and better, and better prices.

Brian:
And I had faith that it was going to come back eventually. Although boy, was it scary at the time, now within a matter of three years, the market had fully recovered and it's just gone straight up ever since then. So, the last 10 years have been extremely profitable period to be an investor, especially in the US market. So, those purchases I made that felt awful in 2008, 2009 and 2010 really have done wonders for my portfolio and returns. Same thing, it felt the exact same way in February and March 2020, the exact same way. It was like you put money in and immediately you lose and it just goes down, down, down, so fast. It was such a fast period to lose wealth and it was even faster on the way up to like, "Nope, the market's going to go straight up from there." So, dealing with volatility is never easy. However, now that I've been through numerous downturns and upturns, it makes it easier to do so, but it's still not easy.

Owen:
Brian, you've published the book. Why Does The Stock Market Go Up? And I often find that it's one of those things that we take on faith rather than on signs sometimes. And I'm really interested to know, like you've written a book about this, so why does this stock market go up?

Brian:
Yeah, that was one of the biggest questions that I had about investing when I first started and even still had multiple years into studying and learning about investing. So many wonderful books that I read all said the same things, right? They said, "Just continually add to the market. There's guaranteed to be periods where the market goes down, but the market will always recover magically." There was never any explanation, it was just, "The market will always recover, just take it on faith that it'll eventually go back up." And I was like, "I don't understand why that's the case. But if you look back, it's always happened." So, it can continue to happen again, but slowly over time, as I learned about stocks and stock investing and markets and the fundamental drivers over a period of years, I pieced together for myself, the answer to the question, which was why, why does the stock market go back up after it falls?

Brian:
Understanding why it was falling isn't that hard, right? Right, now the markets are falling, there's war going on, there's inflation going on, there's civil unrest, lots of interest rates are on the rise, bad stuff happening it makes sense why the market goes down in those periods of times. It never made sense to me why the market would eventually go back up. But to get to the core of that question, you have to really, instead of focusing on the stock market, like the entire thing, it makes so much more sense to really focus on an individual company and really understand what's happening there. So, let's talk about like one of the easiest businesses ever to analyse and think about, and that's just like Starbucks. Starbucks is a very simple business, right? They open up coffee shops, they sell coffee stock for a premium and they make profit from that.

Brian:
A Starbucks stock is up over 30000% since it came in public in 1992, 30000%, $10,000 invested in Starbucks, you are literally a millionaire today. Why is that? Why is it that Starbucks stock is up so much? The answer is that when Starbucks came public, there was only a few hundred of these stores like around the world, just a few hundred, primarily located in the Pacific Northwest of the United States. And Starbucks came public, it sold shares to the public because it wanted money so that it could build more stores. If you look at what's happened between then and today, Starbucks now has tens of thousands of stores all around the world and they continue to add hundreds or maybe even thousands of stores each year to their vast empire. Every time they open up a new store, Starbucks the business earns more revenue.

Brian:
And in addition to that, each Starbucks location that's existed for 10, 20, 30 years, each of those businesses tends to get more profitable each and every year as it goes by. So, why is Starbucks the business so much bigger, so much more valuable today than it was 10 years ago? 20 years ago? 30 years ago? Answer there's many, many more stores selling many more cups of coffee. The company has tens of billions of dollars in revenue and is producing billions of dollars in profits. That's why Starbucks used to be small and now it's big. The exact same principle applies to the stock market as a whole, it's just that it's a lot to understand and analyse hundreds of companies collectively than it is to analyse one business. But in the United States, the most

popular common stock index that we use to measure the health of our markets, it's called the S&P 500, the Standard and Poor's 500 it's 500 of America's largest and most profitable the businesses.

Brian:
And if you look over long periods of time, the S&P 500 just continually goes up. The fundamental reason for that is that the components, the 500 companies that make up the S&P 500 get more profitable each and every year, not in a straight line. There's some big years it's up, some years that it's down, depending on what's going on in the economy. But if you look over the last 10 years, 20 years, 30 years, 50 years, a 100 years, those businesses are far more profitable today, collectively than they were 10, 20, 30 years ago. Ergo, that is why the stock market has continued to go up because the companies that make up these stock market indices have continued to become more valuable.

Kate:
That's a really interesting example. And sometimes people, when they're investing and in our community cannot see that. And then they get stuck, whether it's from things, their family have told them about investing, or they've heard from the news and they just think, okay, well, it has gone up for a period of time, but what if it just all falls apart? How do you help people who are potentially in that doomsday, mindset about investing?

Brian:
Well, I think that the people that have that fear have that worry, will literally exactly in the same position I was 20 years ago when I didn't understand what was going on, I can tell you, I'm personally a nervous flyer, right? When I get on a plane, it's not something that I really like to do. However, what really helped me to become less of a nervous flyer is to understand why does a plane go up in the sky and stay up there? How does it do that? And once I understood things like gravity and Bernoulli's principles and Newton's law's emotion and the air foil and wind resistance, it made me at least understand on a deep, fundamental level. Okay, there are physics at play that keep this plane in the air, it's not just magic when you sit on. So, it just made me a lot more comfortable being on a plane once I understood, or at least had a basic understanding of what keeps this plane in the air. And I really focus on that tremendously when the plane is getting an air pocket and is like turbulence in the air.

Brian:
I truly think the stock market is the same way. It's like stepping onto a plane and just being like, "This will work." Like, "It always works." Just get on. But when the plane starts shaking, if you're like me, you're like, "What's going on? Somebody explained to me what is happening?" That is a 100% of the reason that I wrote my book. It was designed to give people the basic understanding of the factors that cause the stock market to rise over time and that cause there to be short term of volatility. And I think that once you really understand and embrace those, you can at least understand and have faith, true faith that the stock market will eventually reach a bottom and then start to go on to new highs because you understand the fundamental growth drivers in place.

Owen:
Brian it's interesting, the Starbucks examples is a really good one. I think it was Tom and David Gardner from The Motley Fool that went on one of the talking shows and they recommended Starbucks it fell and then they came back and they got questioned, why did it fall? And then five years later it was just, streets ahead of where anyone thought it would be. So, that's a lesson in patience and focusing on the long term. Here in Australia brand, exchange traded funds or ETFs are really popular. I know in amongst our community very popular. Do you have a view on, I guess using exchange trade funds or index funds versus individual stocks?

Brian:
Yeah. I think exchange traded funds are wonderful, I think index funds are wonderful, there are true gift to investors. When people come up to me in life and they want to talk to me about investing and they're starting from ground zero and they say, "What stock should I buy?" I say, "Index funds." I say, "Don't bother with individual stocks, don't even try to do it." And that's not because I don't think they're smart enough to be able to understand a business and figure out a business model and figure out financial statements. Everybody is smart enough to figure out how to do it. However, there's a big learning curve when it comes to going from just buying an index fund, to jumping over into an individual stock investor.

Brian:
And in my experience, 99% of people have no interest in going through the time and the inclination to learn how to invest in stocks simply because it doesn't interest you. And if that's you, that's, perfectly fine. You don't have to know anything about analysing an individual business to do well in the markets. You can stick with broad based diversified index funds and ETFs are one way that you can invest and it really makes it super simple way to get exposure to the stock market. Now, however, if you are in that weird, 1% of people such as myself, that literally enjoys researching businesses, literally enjoys learning about studying businesses and markets. I do think that you can do well for yourself by picking individual stocks, but the huge caveat there is you have to be willing, ready, and able to do the research necessary to learn how to do it the right way.

Kate:
Yeah, absolutely. And if I am interested in searching individual companies and I want to maybe better understand what a company's worth, but I'm not super familiar with fancy spreadsheets, where do I even start? And what are some of the things I should have a look at?

Brian:
Yeah, there's a lot that you need to learn at the out start for me, I can tell you that there are some fantastic books out there that really helped me to understand investing there's two, I will call out. These are my go-to books for a lot of people. One is called Warren Buffett and the Interpretation of Financial Statements, that's a book by Mary Buffet who is Warren Buffet's, former daughter-in-law, she used to be married to one of his sons and she got a front hand view about how Warren Buffet thinks about business and investing and financial statements and in

that book, they literally take the three financial statements, the income statement, the balance sheet and the cash flow statement and she goes line by line through them and teaches you how Warren Buffet thinks about each of those numbers.

Brian:
So, if you want to learn how Warren thinks and how to think through business models, through the eyes of a financial statements, wonderful book for doing just that. Another book I'll throw out there that I really like is called The Little Book That Builds Wealth by Pat Dorsey. Pat Dorsey Is the former head of research at Morningstar and that book is all about understanding competitive advantage and how some businesses produce higher returns than others when studying their moat or their competitive advantage. And both of those books are easy reads, their easy to understand. So, if you want to start learning how to pick individual companies, those are two great starting points.

Owen:
That's great, Brian, because it's such a learning curve, particularly for new people seems so steep and it is, but once you start to piece it together, you pull threads from different authors in this case, people read your book. I think you a really you'd answer to that last question might have been, read my book, but you're very generous and you gave us two others and one I haven't heard of there. What are some of your biggest mistakes Brian, when it comes to investing? And if you're willing to look back on them, what are some of the takeaways that you had in making those mistakes?

Brian:
I've made so many mistakes. I got plenty of lessons to teach on the mistakes that I've made, I think that in itself is a really important point for investors. It's every investor I know even the greatest ones have made tonnes of mistakes. They've bought terrible companies sometimes with leverage, sometimes borrowing money to do so. And they just lost out tremendously on investments and that's just a part of learning how to become an investor. You shouldn't set out to make mistakes, you should still have a process. You just have to understand that you're going to make tonnes of mistakes going through. So, let's tick through some of the ones that I've made. First off, first mistake I made when I was brand new to the market is I got started buying penny stocks.

Brian:
I couldn't tell you anything about their financial statements, their management team, their business models, their competitive advantage, their prospects, nothing. The only thing I could tell you was their stock prices below $5, end of research. That was my research process was I'll buy this dollar company because it'll go to $2, it only has to go up $1 and then I double my money, right? But Coca-Cola, that has to go up like $40 for me to double my money, forget that. So, I did terribly in the beginning because I was buying garbage and I had no idea what I was doing. That was mistake, number one. Mistake, number two, after that fiasco, I started focusing on dividend stocks, right? The highest yielding dividend stocks that I could find. I was like, "Here's a company it's yielding dividend yields 15%. So, I just got to buy this thing, not sell it and

I make 15%. This sounds great to me." Right? Again, zero research, zero knowledge, zero nothing and understandably I lost money because once again I was buying horrible businesses. I just didn't realise it at the time.

Brian:
After that, If got slowly better about investing, about learning, getting my teeth kicked in a couple of times. But beyond that, the biggest mistakes that I've ever made with individual stock investing all contain one word and boy, is this a painful word to say that word is, sell. I have owned at various times in my life, a company called Dexcom, not a very well known company. I bought Dexcom at $6 per share, last I checked, it was over 500. I sold it at $6. I sold Microsoft at $24, last I checked that stock was over 300. I sold Activision Blizzard for $11, last I checked that stock was getting acquired at $87 per share. So, I've bought plenty of businesses that have gone down, right? Plenty of them. But my biggest investing mistakes on an individual stock level were always selling future mega winners, way too early. And the lost upside from selling those mega winners early, it dwarfs any potential losses that I took from holding bad companies for too long.

Owen:
I think that's often missed, right? Because we often don't think more holistically about portfolios and how small positions can turn into massive positions because they keep on winning so, we're very quick to sell. Kate, I don't know if you've got any more questions for Brian this morning. Otherwise we might give you a chance Brian, to tell people where to get the book.

Kate:
Yeah. I think that's probably the most important thing. I believe it is available now in Australia.

Brian:
Yeah. So, the book is available at all major retailers and online is the one I know the best at Amazon, which is a mega seller of books. So, that's where you could pick it up. And while it is focused, primarily on the United States, the principles that are in the book are by far more important than just the numbers and charts and stuff that are in there. And the principles of what a stock is, how a stock and market works, why they go up and down, why they go up over the long term are universally applicable in basically any market that you can think of. So, I still think there's value to it, even though it does primarily talk about the US markets.

Owen:
For sure. Yeah. And a lot of our listeners are most familiar with us companies and many of them invest internationally now. So, it's a fantastic read, Brian, thank you for joining Kate and I on the show. We really appreciate it.

Brian:
Owen and Kate, thanks so much for having me.

Owen:

Kate as always. Thanks for joining me on The Australian Finance Podcast.

Kate:
Thanks for listening everyone.