Episode 53: How do the Financial Markets Work?

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 wondered how toilets in the stock market are related? Well, too bad. You're gonna find out in a few minutes.

Alex Murguia 00:48
Hey, everyone, welcome to Retire with Style. Alex, I'm here with Wade foul and a very special guest. Well, Is that Is that him? Is that Bob French? In the background, yeah. Laughter Hey, hey, everyone. Thank you for joining us today. Today marks the start of a, of a journey of sorts. Now, today marks the start of a new arc we really want to get to, and it's really about investing the financial markets, investing soup to nuts. Why do we want to do this, we realized as we started going over the, you know, the outline for the show, even from the very beginning and the like, we wait and I were looking at each other. And Bob was well, he's always looking at us. We were, we were thinking yet. And we're thinking, you know, the investments really touches upon everything, there's always a place for investments. And if you know anything about us is we really like to drill down on these topics. And so we thought, before we get into the, you know, we did the total return quadrant. And we talked about that. But we also started thinking man as well, you know, at the end of the day, the a lot of these assumptions had to do with investments and capital markets and things like that. And before we got into risk wrap, before we got into income protection, before we got into time segmentation, which again, everything touches investments, we really wanted to just open up the kimono a little bit and just discuss the financial markets, okay? The reason is because I think, even though everyone knows that we need to be invested. I, we're not sure that folks have this true understanding of what the financial markets really are, how they work, what the purpose is. And, you know, I'm gonna throw some of my friends under the bus, if they're listening. There are a few of them, so don't worry about it. But it's this sort of asked me, Hey, what do you think about this stock? What do think about that stock and, and look, it's gone up, and they give me some sort of reason why it's a good stock, and then, you know, there's, you know, you kind of appease them a little bit, but they're you you want them, you kind of want to take them aside and sort of say, Hey, man, this is really how it should be done, etc, etc. But you come across like the wet blanket if you do that over and over again. So really, I think it's worth going over what are the financial markets in its in its one on one level, and I think this will appeal to a broad audience, not just the uninitiated of sorts that you know, kind of like that Woody Allen movie, everything you know, you want to know about sex, but we're afraid to ask this is everything you want to know about the financial markets, but we're afraid to ask let's just go over it. But I think even for advisors, I think there's a there's a level sometimes where they're too far removed. And sometimes from a communication with their clients standpoint, I think it's helpful to know some of the stuff we're going to cover. Now, the last point I'd like to make before we get going here, Bob, and I told you, I was going to hold off because I wanted

to get your take on it. In a and I heard this, it's a way to you know, there's just because you're emotional about a concept, and you have very strong convictions about a concept doesn't really mean that you know, how it and its underlying function, how it truly truly functions you think you do, but then you're like, Oh, I'm not so sure. And putting my psychology hat on a kind of a quick test that you would do sometimes is just I'll ask you Bob, do you know what a toilet is?

Bob French 04:29
I do know what a toilet is.

Alex Murguia 04:32
Do you know how it works?

Bob French 04:34
relatively well. I know the base.

Alex Murguia 04:37
Okay. All right. All right. How does it work? from soup to nuts?

Bob French 04:42
Well, I've ga new one sitting in my garage I have to replace one. I live up in Maine and with all the cold weather it actually cracked my daughter's toilets and their bathroom. So I've got to go in and replace it this weekend. So I will know a lot better in the coming days. But it works through through suction. And, you know, it's Yeah, I don't know. I don't know. You've made your point here Alex.

Alex Murguia 05:10
I don't know. No, but I don't know either, you know, I don't have a clue. Right? Wade We have stumped the chumps, finally.

Wade Pfau 05:20
I've had to fix a few toilets. I don't know if I know what all the parts are called. But I have got the basics down in terms of when you push down on the handle, it lifts up this, maybe it's called the flapper I'm not sure that allows the water to go through. And then when that flapper comes back down, water comes back in and you've got that other device in there that once the water reaches a certain level, it stops more water from coming in. And that's the idea.

Alex Murguia 05:47
I don't know is that an A plus answer a B, it's because also how does the plumbing How does it go in? And, how did this intrude on forests and all that kind of stuff? No, I mean, the larger point is, I mean, maybe we kind of know, but not really, you know, in terms of you know, we didn't get up. There's no, maybe there's a plumber listening, saying, Oh, this boy, this guy's got talent. But the reality is, it's probably that's just the gist of what we know. And so, again, we use it every day. Right? And so the financial markets, it's really, that my buddies that talk about stocks all the time, you know, I really, I kind of want to ask him, How does it how did the markets work? No, really? How? I'll wait. No, go ahead. Right. And so I think this is a good time to really unpack this. And we know, we've done a couple of

courses on this on retirement research are where they've been fairly successful, and people love them. And so Bob, you're kind of the the architect of this. So why don't you lead us about, you know, what are some of the main points we want to talk about today? And then, you know, wait, and I will, pepper with comments.

Bob French 07:03
I think like what you said, Alex, is, it's really, really important to start from the very, very basics of just what it is. That's, that's actually happening here. Because a lot of times people get thrown into relatively abstract conversations. And those are the only conversations they know about the market. But that abstraction is really, really helpful on a day to day level. But it aligns a lot of what's really going on and why things work the way that they do. So let's let's start with the really basic question. What are financial markets? And Alex, I'll turn this one around on you. You know? What are financial markets here, Alex.

Alex Murguia 07:57
Well, like any good math student, I will answer that as no solution.

Bob French 08:06
Okay. We'll go with that.

Alex Murguia 08:08
No, really? That's such a no, no, no, I'll answer that. But that's such an easy, that's such an easy question. I'm gonna let Wade answer it.

Wade Pfau 08:20
Well Bob's notes say is that you hear about them all the time. So I don't know what to say. No, ultimately, you got to bring together buyers and sellers.

Bob French 08:29
Yea this wasn't a trick question guys. It's just people coming together and by selling financial securities.

Alex Murguia 08:42
Yeah, at the end of the day, the word market is there for a reason. And the distinction here is, you know, there's not a, you know, money just doesn't happen, you know, and it's effectively Yeah, you have a buyer and a seller. And it's different from a supermarket, although we'll leave it at that. There's an engineering component to that. But yeah, we'll come back to that one. Yeah, that's a good point. But the word market is there for a reason. It's not called the stock arena. It's not called the stock pit, although, you know, for some people, maybe, but yeah, it's a stock market, where you're bringing together a group of buyers and sellers, to effectively agree to some extent, although it starts from disagreement to agree on some sort of price. Right? And we can talk about what they're agreeing on and so forth. But you're, you're effectively doing that within the stock market, and you're effectively doing that within the bond market. So it's effectively an auction place. Think of it as an art. I think that's a good word. Right. But I really wanted to start off with think. Yeah, think of it as an auction place for the right to buy a sliver as you'd like to say about a security.

Bob French 09:47
Yep. Yeah. And that kind of brings me to the next question of, you know, stocks and bonds. I mean, one of the really crucial things that I think people on the stock side, intellectually know, but they don't really internalize is that stocks are just, as Alex said, little slivers of ownership. In a company, when you buy a share of, of Amazon, you own an infinitesimal percentage of how of Amazon you own, you know that point 00 something percent of Amazon, you have a claim on the cash flows from Amazon in the form of dividends.

Alex Murguia 10:29
I, I want to say that's a very important phrase that you hear a lot of, well, you hear it with, you know, teachers use it, you have a claim on, you have a claim on I think that's a very, very important phrase, because it instills this ownership, you know, unlike buying a house where you can touch, you know, effectively owning stocks or bonds to some extent, especially, I don't think stock certificates gave you all that closure to touch something, but you have this right to that equity,

Bob French 11:02
You are a partial owner. So you technically have, again, with Amazon, you technically have all of the same rights as Jeff Bezos, he's got a lot more of those shares. But every share, by and large, you know, is exactly the same. Bonds, it's even Alex, I'm sorry, go ahead.

Alex Murguia 11:24
Yeah, well, none of the bonds,

Bob French 11:26
bonds are even simpler. Bonds are just alone. When a company or a government issues a bond, they're taking a loan from investors, they're going out and saying, hey, I want to borrow this money. And I will pay you 3% interest in the form of these coupons every six months. And at the end of 10 years, or whatever it is, I'll give you your money back. That's literally all it is. You know, people get really kind of esoteric and go way down into the weeds on especially bonds. But they're like the simplest financial instrument out there. It's literally you give the company money now. And they promised to give you back that money and more in the future. That's it. For our governments

Wade Pfau 12:21
and the secondary markets, so you're not committed to holding on to it the whole time, you can sell that loan that you've made to someone else, so that they became to

Bob French 12:32
close the loop on going back to stocks about kind of why you're coming back to that secondary and primary market that you're about.

Alex Murguia 12:41
Well, before, before that one, Bob, before the secondary. Because I think that that's good later, later on. I still want to cover one the piece about the logistics on the auction. Because again, I think that's

important where, okay, there's a magical auction place, but unlike there's no like store manager or the head of the dairy department or something like that, that's managing that store. How does it work within the within the auction? You know, how does it work on the floor of the exchange? Because I think you hear a lot lately, probably a few years ago, the sort of the high frequency traders and you know, you can't do anything because they're selling millions of dollars, or, you know, recently Oh, the market makers, Citadel, the market maker. Yeah, that kind of thing. Talked about that dynamic.

Bob French 13:25
I definitely want to talk about high frequency traders. But let's, let's put them off to the side a little bit. So getting back to just the normal operations of a financial market. You know, I think most people have seen pictures of the Pitt, the New York Stock Exchange, that really big room with like some pillars going up there that you've probably seen. That was where stocks got traded for a very long time, they moved over basically all to computers now. But it's a really easy way to think about it. So that room was so big, because there was someone for almost every security, someone called a market maker. And literally, they were holding an option on all on each individual stock. And there was just this massive pool of people around them all basically yelling prices back and forth. And they were facilitating buyers, finding sellers and sellers finding buyers and kind of collecting all of that information. So that people kind of knew well, where the market is, what is the going rate on a share of Ford or Tesla or pick your company? You know, that was the whole idea. You get all of these people in a room together and let them hash it out. Let them kind of figure out where where it lies. Now, moving over to the high frequency traders. You know, there's a lot of, as Alex says, kind of couple years ago, we heard a lot about these folks. Almost all of it bad. But if you're a long term investor, which most people who are listening this probably are, they are an unalloyed good for you. They are out there buying and selling constantly, because they think they found these tiny little imperfections in the prices. And they're trying to capitalize on that. Well,

Alex Murguia 15:30
....Good?

Bob French 15:34
Yeah, okay.

Alex Murguia 15:36
Wade, I swear to God, that he was gonna use the word platonic at some point.

Bob French 15:41
Don't worry. It's funny Alex you're saying that, it's literally in the outline I put together here. But, no. I mean, it's there, high frequency traders are out there, doing what they're doing. And they're trying to, you know, whether they succeed or not, they're trying to find these tiny little imperfections, they can kind of pick up. Now, if I'm out there trying to day trade against them, assuming that there's some validity to what they're doing, I'm gonna get killed. But if I'm a long term investor, I don't care about those. Second, by second price changes, what I care about is the fact that they're buying and selling so much, that there is so much more liquidity in the market, it's a lot easier for me, as a long term investor, if I need to go in, well, shoot, I got my, you know, I got my paycheck, I'm gonna go in and invest my 401

K contribution. Now it's cheaper to buy those stocks. Or if I'm someone who is going to be, you know, taking money out in retirement, I'm going to be selling well, now it's a lot easier to sell, there's a lot more people looking to buy this stuff. So it's just making my life as a long term investor, just a little bit easier. So it's really, really easy to kind of demonize them. And, you know, they certainly make it very easy a lot of the time. But in terms of market operations, it's a good thing for long term people.

Alex Murguia 17:22
I agree. And that I think that transitions nicely, right, just off the top of my head. No, but that they serve as it helps with the eventual price discovery of all of this, would you say.

Bob French 17:35
exactly. And, you know, one thing that's that's worth pointing out is just how massive these financial markets are. So you know, you have these, again, this is a few years back, they're still out there. But they're not as big of a story anymore. But the high frequency traders are buying and selling a ton. But the overall size of the financial markets is just truly staggering. To the point that they're not having such a massive impact. So put some numbers around it. At the end of last year at the end of 2022. The market caps, the valuation, the value of all of the stocks in the global stock market was 62 was about a little more than $62 trillion. And when we start getting numbers that big, it's really, really hard. Just conceptualize what that means. You know, another way of saying

Alex Murguia 18:31
that's 50, Tesla's that's 50 tesla's.

Bob French 18:33
Uh 47 Tesla's there. No, I mean, just putting it a different way, it's 62 million million dollars. So I mean, it's just phenomenally big. And it's important to remember the global stock market is significantly smaller than the global bond market, the global bond market war. Yeah, it's not even worse. The stock markets. I don't have the numbers in front of me for right now. But a few years back, this bond market, the global bond market was more than twice the size of the global stock market. I don't know if that's still true, but it's going to be on that order of magnitude type of frame. If you're looking for more personal advice, please know that our show is sponsored by McLean Asset Management. Learn more at McLeanam.com. That's McLeanam.com. McLean Asset Management is a wealth management firm where we help you design and implement the right retirement plan for you.

Wade Pfau 19:38
And it's probably worth commenting a little bit on how does a company decide if they need to raise funds? Do they sell themselves in the stock market and give away ownership shares or do they borrow on market? That's that's an investor's perspective to know that what is the difference between a stock and a bond?

Alex Murguia 19:56
That's a great question that that that leads to why they... would that actually another way of asking that question, which is right is, that's why that's why there is a stock market at the end of the day. Yeah. What? Why is there even a stock market? Bob.

Bob French 20:12
Yeah, so like I said, there's, there's really two ways that companies are interacting here. So they can issue stock, or they can issue a bond. So bonds, again, real straightforward. They're going into the market and saying, hey, I want to borrow some money. And I want to borrow it on these terms. And here we go. Stocks is both at the same time, even simpler, but a little bit more complicated. Because when we think about going to the stock market investing, we're thinking about the secondary market. So what that means is I'm buying, you know, Apple from Alex, Alex owns a share of Apple. And I would..

Alex Murguia 20:57
I'll never sell Bob never sell

Bob French 20:59
diamond hands.

Alex Murguia 21:01
I think I think differently.

Bob French 21:04
I'm buying from Alex. In that case, Apple has literally nothing to do with the transaction, they don't get any money. I can just, I now have the right to show up at their, you know, their shareholder meeting and try and kick out Tim Cook if I really want to. So, or if it's Berkshire Hathaway, I get to go and show up to Omaha for a party once a year, basically. Where are the companies?

Alex Murguia 21:33
I mean, I can see why you would want to kick out Tim Cook. I mean, why would you put glass walls everywhere.

Bob French 21:38
But where the companies has come into play is what are called initial public offerings, or well, the big one is initial public offerings, or IPOs. And if you're listening to this, again, you probably have heard that term.

Alex Murguia 21:57
Bob even with that, I think with Wade was saying, and I think I want to set this up, I hope you don't mind. And this is part of having three of us here and I get it. But I think it's important, especially when we talk down the line on premiums. I want to make this point because I think it's very important and Wade said it is okay. So I'm a company Retirement Researcher, McLean right, let's say the Risa right. We're a company right. And we're right now Wade and I, Bob as part of the reason we're running this, and it's you know, it's effectively a startup right now. And let's say we start growing, we start getting this interest in this, Wow, I love the Risa let's do it, you know, let's let's back it up, you know, I can just use the revenues from the Risa and use it to fund my growth, you know, waiting i period pay each other last, and we use it to fund growth, right? That's one way of funding future growth or making sure we can

pay our bills. Another way is, let's say we have these growth plans, but the revenue doesn't match. What do we do, right? There's no money tree. So wait, and I can borrow from the bank. Right now we take a Small Business Loan Borrower from the bank, we have our own personal credit. And we're good, right? The bank funds us and we go about doing our things. Or I have a rich uncle. Now let's go I have a rich, I borrow from a rich Uncle Dave, you're listening now from a rich uncle. And there we go right. Now, you know, problem solved, right? Good luck, then. The other one is, I borrow from a pool of investors. I borrow from a pool of investors, you know, we create a syndicate, we borrow $5 million, we attach an interest rate to it, that interest rate is going to be different than the bank because of certain risks. And we'll get to that later. But it's done. You know, I'm in the bond market now. Right? Or the stock market. Now, why would you even do an IPO? And I think that's important, cuz some folks are like, you know, you know, let's say about internally, and those people want to get back or some people invested, and they want to get that money back, or I still need to fund these growth plants, right. But I've exhausted it makes, it doesn't make capital sense for me to borrow from a bank, it doesn't make capital sense to issue bonds. And so what I do is, I, I, I'm going to put to the stock market, I'm going to put an open market 30% of my company, I'm going to sell 30% of my company in an initial round, not the secondary round, which Bob was talking about in an initial route. So I get investment bankers, or you know, they're doing things differently. But let's just say traditionally, I get a bunch of folks, they help me sell that into the open market. I sell, let's say I value the Risa at $100 million. We want to raise $30 million, we sell $30 million of our company, hopefully we get 30 million back or more, who knows, you know, but I've cut it at 30% Maybe, uh, you know, that number can fluctuate and we'll talk about that later, when we're talking about premiums, if you will, but effectively, I've sold myself in the open market in the end Initial Public Offering, I've gotten back hypothetically, the $30 million, the company I own, we all in aggregate before the offering have 30% less now, because that's how much we get, hopefully, you know, it could change in the in the fringes there, depending on the price discovery of that, but that's what I'm hoping for. Right. And there's money in my hands, that I can now pay back early investors, I can pay back loans that they're knocking on my door for I can use it to fund future growth. That's why ultimately, somebody goes to the stock market, you know, relative to borrowing from the bank using revenues to fund growth, having a friends and family around, or, you know, doing it in the open bond market, if you will, Bob, did I miss it?

Bob French 25:48
That's, that's actually exactly what's going on in that part there that a company is only going to go and raise money for a reason is really important for people to understand. Because when I talk to people, a lot of the time, people seem to think that just because a company is a big company, whatever that happens to mean, exactly they can they there's obviously going to be on the stock market. Yeah, a lot of them probably are because they've had to raise money at some point in time to fuel future growth. But they don't have to, there are some really, really big companies that are privately held that are not publicly traded. And, you know, after 2008, a lot of publicly traded companies decided they didn't want to be publicly traded anymore. So they went private, they went out to the market and bought back, all of the shares that were outstanding are a big, big proportion of the shares that were outstanding, and took it private again. So it's something that a company is actively choosing to do for a very specific reason.

Alex Murguia 27:07

But the key here is that it's all a form of financing. It's all a form of financing. I'm saying that twice for emphasis. It's all a form. Now, if that's the key, I mean, like I said, if you don't need the financing, you don't need to go public, right? You can borrow, you know, through various avenues. So it's just a form of financing. And you can make the case it's the riskiest to some extent, because of the ownership exchange, and because also as an investor, it's a different kind of bet. Hence, you know, you can get into why there's a premium going forward, etc, etc. The other piece, though, you said secondary market, and you're right, Apple now once Apple goes public, three days later, there's there's open shares, changing hands. Talk about what happened recently with AMC and Gamestop because these companies themselves become active participants.

Bob French 28:02
Absolutely. So there's a lot to talk about with AMC and Gamestop and the whole meme stock ecosystem

Alex Murguia 28:10
Spare us your 10, bagger. Spare us your 10 bagger story and just get to the

Bob French 28:18
What part are you driving at? Actually, Alex, there's a lot going on.

Alex Murguia 28:23
All right. It's specifically more the companies themselves recognize, okay, there's, it's a form of financing. It's a form of financing. So, all of a sudden the stocks shot up.

Bob French 28:32
the sudden the stock shot up after that whole kerfuffle and

Alex Murguia 28:40
Kerfuffle? Wade, did you hear that one? I'm gonna tell my kids to listen to it. They just did their PSATs and I'll say you gotta You gotta listen to Retire with Style. Bob's just throwing out some gems today.

Bob French 28:52
This is what happens when you...

Wade Pfau 28:54
run that case, he helped keep the E rating of the podcast using that instead of some other. So thank you Bob.

Alex Murguia 29:02
Yeah, so thank you Bob.

Bob French 29:03
What we're talking about is...

Wade Pfau 29:04
Alex would've

Alex Murguia 29:06
Wade, I would of, Wade, I would have caused imbroglio, imbroglio

Bob French 29:12
So, towards the height of you know, when these companies got really, really highly priced. These a lot of the companies went out and issued more shares. Because effectively what they could do is they could go in and say, you know, basically get a higher price for that little piece of ownership, you know, they can go out and issue you know, give the market 5% more, I have no idea what the numbers were off the top of my head, but they could sell 5% More of the company and bring in just a whole bunch of more money than they would have six months prior. And this is actually pretty common when you see a really big run up in a stock price. Especially if the insiders, the managers and you know the large shareholders don't think it's really tied to the true value of the company, they're going to go out and try and take advantage of that they're going to try and issue more shares. So they have more money, and they don't have to pay as much in terms of ownership as they might have otherwise.

Alex Murguia 30:22
So, think about this. So AMC was in or whatever trading at 10, let's say, all of a sudden it goes to $80. A share, right? That those those the people, the executives, regardless of why, and it was this whole sort of mean trading, etc, etc. Regardless of why the executives are like, that's the open market price. I'm gonna, I'm gonna flood the market with shares, new shares, not existing shares, it's like a new offer. And what they effectively did, yeah, what they effectively I don't know, for how much or whatever, but lets you they were able to raise an exorbitant amount of money on a really a feat artificially high price, which, yes, it diluted their company. But they took that, you know, since they were new shares, they took the proceeds, you know, for their own treasury, right. So they have it now in their books, that money, which they can then you know, they fortify their balance sheet. Yes, the stock goes down after they do that, because there's just dilution. But the reality is, it was a shrewd move, whereas GameStop, I want to say they sat on it for a long time, like, just not, AMC acted very fast GameStop. I don't know if they ultimately did it. I think they ultimately did arrays, but it was like, they were just like observing AMC, and you know, following their playbook, but a little too late.

Bob French 31:45
You know, in fairness to them, these are not things that are very quick and easy to spin up. It's not like you can just get on the phone with Goldman and say, hey, I want to issue some new shares, and get done by the end of the week. There's, there's some some work that needs to be done. But you know, when you see blips happen that big, they're gonna figure out how to get done pretty quick if you want them to. And, you know, it's also worth calling out. This goes the other way, as well. You know, and we hear a lot right now about share buybacks where a company will go to the market and buy back shares that have been previously issued. So you know, if I own again, I don't know why I'm picking on Amazon today. But Amazon decides that their stock is underpriced. Based on what they as the managers and large shareholders know about the stock or know about the company, they think Amazon is underpriced. They can go out to the market, just like any other participant and say, hey, I want to buy,

you know, your shares of Amazon, I want to buy this much Amazon and bring it back and effectively D-ish. That's that those shares? And, you know, a lot of the commentary is that how evil this is, and how bad this is. Again, it's not, it's, you know, just the company is a another market participant, there are some games that the executives can be playing around executive compensation and triggers in their contracts and stuff like that. But conceptually, it's not that big of a deal, if anything, is just another form of dividends, that's coming in the fray, or in the form of the price rising.

Alex Murguia 33:39
Exactly. So think about this, if a company has $50 million of capital that they want to put to work, right, they could put it to work by R&D, you know, we're gonna do some research design, and we're gonna go into new markets or whatever, right, we're gonna, you know, the next best thing we're going to figure out, they can put it to work by saying, you know, what, we can't use this capital as as well as our investors can individually, so we're just going to issue a $50 million dividend in aggregate, right, and give it back to everyone, because that's the best use of capital relative to what we can do with it. Or they can say, we're just going to eat up maybe for tax reasons. But I yeah, do people play games? Yes. But it really is a it's just a use of capital, right? They could say, Look, we're going to as opposed to giving dividends to shareholders, we're going to just buy back stocks in the open market, and that will theoretically reduce the float and increase the price. That's, that's outstanding right now, because of the pressures involved. That benefit shareholders, you know, as well. And so yeah, I mean, I'm not going to excuse somebody that gets $50 million in government money and then tomorrow goes back and buys $50 million, whether the stock I we get that, but let's talk about the Uh, the usual the usual use case, if you will, which is companies, you know, they have a net present value calculation that they do for their cash, you know, for they do for their existing cash and then they decide buyback dividends or reinvest, you know, effectively that's the, am I missing it? That's pretty much it.

Bob French 35:19
No that's basic...

Alex Murguia 35:21
Buy a Superbowl ad sorry, buy a Superbowl ad, buy back stock or dividend,

Bob French 35:27
it's a question of if they keep the money internally, they're saying, I have, you know, comparatively good investment opportunities, I can do better than average with this money. If they don't think that's a true statement, then they're gonna issue dividends, they're gonna give the money back to investors in some fashion that can be traditional cash dividends, or that can be a buyback, which is effectively stock dividends, because they're raising the price of all of the other shareholders. And also giving you know someone the opportunity just to get get out. If they don't want to own the share at that price. It's perfectly, perfectly reasonable. And you know, this is something you want to dig in more. Take a look at some of the stuff Cliff Asness over at AQR has been doing. This has been his hobbyhorse for a while now. So there's he's got some good stuff on it as well.

Alex Murguia 36:23

Now, Bob one of the things and probably theoretically should have hit it up earlier, but from an from a price discovery perspective. And I think it's good for folks to hear your thoughts, because I even heard a thing on Twitter once following the stream. And an advisor asked why why do you know should shorting be allowed? Which I find it kind of weird? That, you know, they didn't know that, you know, to a large extent, but what's your take on shorting and I'm coming at it from price discovery.

Bob French 36:55
Let's actually talk a little bit about what price discovery means.

Alex Murguia 36:59
Yeah, and what shorting is actually,

Bob French 37:00
This is about 3 levels deep here. So the idea of price discovery is, you know, we talked about the stock market as literally just this big room of people all yelling at each other, you know, buying and selling stocks, you know, that continuous auction, you know, all those like movies from the 80s, you know, with the people at the exchange yelling at each other with the phones on both sides of their faces. That was real. That was not an exaggeration.

Alex Murguia 37:32
What movies of the 80s are you referring to Bob? Trading Places, trading places. Motimer, we're back.

Bob French 37:50
But yeah, I mean, that stuff was real. And so it's people buying and selling all the time. And one of the really, really important things is that they've all got skin in the game, this is all by and large, their money, they really, really care about getting it right. And that doesn't mean they're always gonna get it right. But as a group, with all of these people in that same room trying to do exactly the same thing, and crucially, disagreeing with each other. As a group in aggregate, they're going to be bringing all of the information, all of the available information to bear, they're going to be bringing all this information and putting it into the price of each individual security. And crucially, that also includes not just like, what we know about it not like, you know, the company's annual reports and things like that the factual statements. It also includes the expectations, it also includes people's guesses about what's going to be happening in the future.

Alex Murguia 38:58
Yeah, and so and so to that point, like, what are you doing, when you're essentially shorting to answer my own question, I guess, what you're doing when you're shorting to spare you the logistics of it, you're betting against the price of the stock, right? So you're betting against the price of the stock so that if it goes down, you can lose a lot of money, you can lose more so than then it going up, you can lose you can be like underwater, you could be below zero,

Bob French 39:26
It's literally the inverse of buying a stock.

Alex Murguia 39:31
So so the the point that I'm just trying to make whether it's right or wrong is they're providing you know, when you're buying you're providing price discovery pressure on the upside, the other way provides price discovery pressure on the downside and in the middle of the two shall meet kind of thing and so it's not a bad thing theoretically, you know, bottom, you know, point blank, there it is right and it helps just, you know, the best disinfectant is sunlight and I, you know, I think shorting kind of has that effect. on stocks if you will.

Bob French 40:01
Thinking about it. I'm sorry, I apologize.

Alex Murguia 40:05
Well, because I think you also then make a great point about not many times, Bob, and I agree like this. No, but he's making a great point on the aggregate wisdom of the crowds, if you will, you know, in terms of the price discovery is based on a lot of a lot of a diverse sample of folks really providing their best estimate on what the value of something is. And the best estimate of many, many people over and over is, is significantly better than the estimate of just one observation. You know, if you get a time, you can explain it better than I can that the whole Jelly Bean examples, I think is a great one.

Bob French 40:47
The Jelly Bean example is a classic one in the at least the advisor community or our corner of the advisor community. It was a who says almost 10 years ago now, I think it was the early 20 teens. A, an advisor had like a client event, you know, he brought everyone together for this dinner. And at the entrance, he had this massive, massive jar of jellybeans. And, you know, he basically had I forget what it was, it was a raffle or something. Where it was, you know, guess the number of jellybeans and the person closest to it, you know, wins the raffle?

Alex Murguia 41:32
I think was, I think it was

Bob French 41:33
absolutely Wade's book, like five years before it came out. They're gonna be the first person to ever get it. And, you know, one of the things that, you know, obviously, no one is like a professional Jelly Bean guesser, no one can really look at this thing. And, you know, be able to tell you, there's 7836 jelly beans. Maybe Maybe you can, Alex, but you know, it's

Alex Murguia 42:06
I've eaten that many. But,

Bob French 42:09
In one afternoon, absolutely.

Alex Murguia 42:11
Yes, absolutely.

Bob French 42:13
So where I'm going with this is, is no one really has any clue. But what they found in the reason they did this was that when you aggregated all of the different guesses, and you know, the lowest guess was just absurdly low, the highest guess was absurdly high. But when you average all of those guesses together, it was off by and I don't have the number in front of you. But I think it was like 50 Jellybeans out of like almost 10, doused. No one actually can guess or can count how many jelly beans were in there. But by combining all of this information by combining everyone's guesses, we got to effectively the right answer. And think about what that means when people actually care about the answer. Wade, I know you're not getting that first edition of your book is a massive, massive draw. And we all spend a ton of time trying to get it right.

Alex Murguia 43:15
Are you kidding? That's like Mickey Mantle.

Bob French 43:18
These people are not quite so enlightened. You know. So they were just guessing offhand. They're just taking a wild guess. In the stock market? Very, very few people are taking wild guesses. They're doing absolutely everything they can to get that answer, right. They're using all of the information available and all of the disagreements about that information. Curious if you should be looking at a Roth conversion or what a Roth conversion even is. Head over to McLeanam.com/roth to get McLeans free ebook Is a Roth conversion right for you and learn about when you might want to do a Roth conversion. And when you might not just head over to McLeanam.com/roth To download your free ebook today.

Wade Pfau 44:06
But then there's another issue too, and I think this jelly bean example I've heard it never in the context of a financial advisors the kind of classic the wisdom of crowds, the average guest turns out to be pretty accurate, but no one individual got there. But with the jelly beans, you can ultimately count up the number of jelly beans and know what the answer is with the value of a particular company. It's not so easy to know what it is.

Alex Murguia 44:34
Wade, what are you doing, man? What are you doing? Wade. What are you doing Wade?

Bob French 44:40
Because it's true. There is no photonic price. There is no true value or knowable, true value for any individual company. It's what people think it's worth. And to use another slightly old example. You know, one of the great example.

Alex Murguia 45:00
Wait, he did say platonic price, I just had to bring that up. And he did bring it up.

Bob French 45:05

But it was a really, really great examples of this about expectations and differences in those expectations is Apple, I want to say it was 2012. The Apple had, you know, the fourth quarter that year, they had, I believe it was the second best quarter that any company has ever had up to that point in time, they announced it. And the next day, Apple's stock price dropped by 10%, which is, when I give you that set of information, pretty counterintuitive, you know, someone that a company has the second best quarter ever, you would expect that their stock price, the value of the company would rise. But it didn't, it dropped by a lot. Because the expectation would be those profits, those numbers would be even better. Everyone had built those numbers, those types of numbers, into their expectations into how they were valuing apple. And when we got those numbers back, when we got those, you know, not so great second best quarter of a company ever back, everyone had to lower their estimates of what Apple was worth. And, you know, that really drives that how all of this stuff. You know, when we get new information, it's not about the information in and of itself, whether it's good or bad, or whatever it happens to be. It's how it squares with what was expected to happen.

Wade Pfau 46:50
And I think that's really the basis of the expression, the Random Walk Down Wall Street, or the idea that the stock market follows a random walk, that the price right now incorporates the expectations and beliefs of all the market players. And if, if you believe the price will go up, you go along, you purchase the asset, if you believe the price will go down, you have the potential to go short. Maybe that people just think that's a bet against capitalism. But then once everyone makes those decisions, it's only the unknown. We don't know what the news will be. The unknown is what then drives the next price movement. And if that expectation was that Apple was going to have an even better quarter, and it didn't, that's where the new information is, oh, this is not as highly valued is the aggregate kind of average person in that market thought it would be.

Bob French 47:42
Alex, you were about to say something.

Alex Murguia 47:45
I was kind of being nitpicky. But I don't know I just kind of in my head when Wade made the statement. You know, if you believe Apple, Apple's price will go up. You go long. And there's a there's a caveat to that. I I

Wade Pfau 48:01
Or if you're a long term investor.

Alex Murguia 48:02
Yeah, kind of right. I know, I'm being nitpicky here. It's more the statement of I don't want you to think you go I know you don't mean this. It's not that you'll go long because there's an arbitrage because technically, you feel the value right now is being under priced. The value of Apple is under price relative to unknown information. I think you're saying Apple will go up, you'll go along, because Apple participates in capitalism, and you know, they're going to continue to make earnings, they're going to continue to, you know, things will continue to go along the path of a normal economic environment. And

you just don't mean Apple, like just buy one stock and let it ride using Apples as an example of that. That's kind of what I want to ensure.

Wade Pfau 48:48
Yeah, you believe markets will grow. And therefore you want to be long, you want to own a stake in the overall economy to benefit the growth

Alex Murguia 48:55
Yeah and obviously, you want to diversify away from one stock, etc, etc. But that's for another time. That's that was my thing. And I'm being nitpicky.

Bob French 49:02
It's also worth calling out for the short term investor. This is a person who thinks they can beat the market. You know why they would be going out and buying Apple or selling Apple or shorting Apple or whatever it might happen to be the in that particular case, you know, if I'm someone who, you know, is doing fundamental analysis, and I'm saying, you know, hey, I think Apple is worth more, let's say, apples trade, I have no clue what apples trading at Apple is trading at $200 Right now, if I think Well, now, I've run the numbers and I think that's actually $220. Well, I'm gonna go in and buy as much apple as I possibly can within the confines of my portfolio. Because Apple is on sale. Apple is cheaper than it should be. And my expectation would be the market would come up to it apples true value. Now, no, in a few episodes, we'll start talking about why you might not Want to do that. But that's the logic inherent in the in in the market. And by buying up Apple by buying shares of Apple again, remember, we're just in an auction setting, I'm sending a signal to the market apples underpriced, I'm pushing the price of apple up by going out and buying apple. Conversely, if I think Apple is overpriced, I think it's a worth $160, I'm gonna go out and sell Apple at 200. Because well shoot, it's $40 More than I think it should be. So I'm going to Well, I'm gonna go pocket that money before the market starts coming down. And I'm at that point, pushing the price of Apple down with those sales. That's the magic of the market. That's that price discovery mechanism, that every time I do something, I am influencing what the price of that security is. I'm when I think it's undervalued and I go in buy, I'm pushing the market up, I'm pushing the price up, when I think it's overvalued and sell, I'm pushing the price down. And with enough people, even though we talked about how massive these markets are, but with enough people who are doing the same thing, and making those same sets of decisions, again, slightly different sets of information, the market converges on at least a reasonable assumption for what those prices are, or should be.

Alex Murguia 51:32
It's, it's not and we're getting to this in the arc, but you know, it doesn't matter, peppering it now. It's not too different than the spread between a football game in Vegas, you know, in which the spread the first day, there's a matchup it's such and such information starts coming out injury reports, whatever, it starts tightening and starts moving around based on the you know, the tilt of the of the spread, you know, and being a come game day, it's the best estimate of people that are actually putting their money down. And you don't, and you don't want you don't win the bet by just saying the Patriots are going to win or the dolphins are going to win or anything. It's you got to you got to hit the you got to hit the spread, if you will. And so you know that that translates to prices or prices or that sort of expectation.

And over time, you know, if you think you're finding something that the market hasn't I, you know, good luck. I mean, this and I do want to bring this up, because we can say all of this, right? And at the end of us talking and I think we're wrapping it up soon. So at the end of us talking, somebody listening in, we'll have this and one of my friends, you know, among, you know, a group chat, if you will, literally I get this there wasn't intended to be there and asked me anymore. But but it's really Palo Alto, or CrowdStrike, or both, or neither as stocks to buy, right. And then the response by somebody is, you know who you are. If you're listening in your buddy right now, both solid companies that are doing well in cloud storage and cybersecurity, why they are only trading at seven to eight times. My concern with both our customer retention given they rely on subscribers, their growth over the last four quarters isn't sustainable. And I'm not convinced the market as realistic expectations. one trick ponies with limited lines of revenues, Apple, Microsoft, Amazon, Google, Intel, Disney, etc. Have multiple lines of revenues. By the way, Amazon and Google have been penalized lately, and you may see some spikes there. Okay. Wade, so which is a way Palo Alto or CrowdStrike? No, but...

Wade Pfau 53:44
That's just very if you don't, what's your reaction? You do better than the aggregate? Well, I just don't get into the trying to guess individual stock direction.

Alex Murguia 53:54
No, but I think this is important from the sense of what we want to do today, which is how the stock market works within that context. You know, what, what, how would you respond because I can't respond to my buddies anymore in a manner that they're like, Oh, it's just Alex being Alex, you know, kind of thing? How would you respond Bob in a real real way?

Bob French 54:13
The fact that we're talking about this type of information, means that it doesn't matter from an investing standpoint, that information, those worries about client retention, and all that type of stuff. That's already in the price. That information has already been included in, you know, the price of Palo Alto, and you know, every other company out there. So what I'm worried about is the stuff we're not talking about, if I was to try and go out and you know, pick a company to buy. I'd be worried about, you know, all of the information we don't know all the information that isn't in the market. And unfortunately that also means all of the information. I don't have. You know, so, if you give me two companies, I am You know, absent some of the things we're going to talk about later on, I'm indifferent between two companies, I would say buy in bulk, and buy everything else.

Alex Murguia 55:12
I would say buy Palo Alto because CrowdStrike had a Superbowl commercial. But that's just me.

Bob French 55:17
Ah well that changes everything.

Alex Murguia 55:19
Wade, Wade you were saying.

Wade Pfau 55:21
What you were describing with that comment? You could see where there was a sense of recognizing there is an overall mark, because they're saying things like, I don't think the I don't think the other market participants are truly pricing in or under prey. I forget the exact word. Yeah, it was a sense that I know more than the aggregate participants of the market. And that's rarely going to be the case in real life is all I can really say about that.

Alex Murguia 55:49
Yeah, no, but the reality is like the market, so in a general sense, how would you define the market then by Wednesday, when you when, in fact the same way as to what is the toilet? How does the word market in you know, elevator conversation? What is the market?

Bob French 56:03
The market is just the aggregate group of people buying and selling securities buying and selling stocks? Well, slivers of ownership and a company buying and selling bonds, which are just again loans. And that's all it is. It's nothing more complicated than that is just a bunch of people in a room trading stuff.

Alex Murguia 56:27
My go to as always, it's a mechanism for financing. Wade.

Wade Pfau 56:35
Okay. No, I think that nails it in Yeah, we we are running on the long side here. So we should wrap up and this is part of an arc. So we're going to continue with this series in the coming weeks. Week two in particular, this series will be more on why do you invest? We may touch that on a touched upon that a little bit this week, but we'll dig into that in more depth in the next episode. So thanks, everyone, for listening and we'll catch you next time on Retire with Style. And thank you Bob, for being our guest this week.

Bob French 57:04
Thank you guys. 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.