The Australian Finance Podcast Episode Transcript

Episode: Share Investing Q&A: Blue Chip stocks, takeovers and jargon galore!
Release Date: 24/05/2021
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Duration: 47:55

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Episode transcript:

Owen:
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Owen:
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Kate:
Welcome to this episode of The Australian Finance Podcast. This is the fourth episode of our shares month series and we're going to be answering all your questions, and to do that I've got three of our analysts here at the team at Rask Invest. I've got Owen who you know and probably don't love. I've got Kevin-

Owen:
What?

Kate:
Kevin and I've got Cathryn Goh who you met in episodes two and three, so you'll be a little bit familiar with them. But we had some great questions come through, and I'll just throw it over to Owen to make sure that everyone's aware that this episode is not financial advice.

Owen:
Yes, this episode is 100% maybe not financial advice, so this is a serious disclaimer, if we answer your questions what we are actually answering is just a general nature, so we're not answering personal advice questions, you need to see a financial planner for that. You can find them online, there are many episodes we have done discussing how to find a financial advisor.

Owen:
A lot of the questions that are coming through today involve investing, and investing is an uncertain pursuit, so there is risk involved, there is risk of permanent capital loss, although that hasn't happened much in my career, because normally you make good decisions before you buy and while you hold a company. If you need to learn more about investing, I would highly encourage you to take our beginner shares course and listen to a few of our podcasts from early on, and they set the groundwork for what we're about to do here.

Owen:
Okay Kate, you're host for this episode if I'm not mistaken.

Kate:
Yeah, that's going to be fun. Just a reminder, if you haven't listened to episodes one to three of our shares month series I'd encourage you to go back and do that, because it'll set the stage for today's episode. So I just wanted to ask everyone the same question to start, we've gone through the share investing checklist this month, there was five key components on there being, understanding what the company does, who runs it, what their moat is, whether they're in a growing industry and what's the valuation. So I wanted to ask each of you, what's the most important item on your personal share investing checklist? I'll start with you, Owen.

Owen:
My first thing is making sure that, and Cathryn's got a smile on her face here, is making sure that the company is built like a brick shit house. That means that the company is rock solid, just like the dunny out the back, it's built well. What I'm looking for are a strong balance sheet, so no debt or very little debt, and at the worst more cash than debt, so even if it has debt, it's got more cash. And cash flow, which is something that Cathryn's going to talk about in a minute, but just making sure that it's cash flow positive. You can check in the financial statements, which is part of the annual report, you can find the cash flow statement, which is normally the fourth statement out of four, it's the one at the end. People tend to forget this one, but it's the most important and look for operating cash receipts, or operating cash flows.

Kate:

Right, so making sure there's not too many red back spiders under the hood.

Owen:
Yes, you do not want to park your butt on a red back.

Kate:
All right, right so Cathryn, what is your important thing?

Cathryn:
Mine is starting at the very top, so understanding the business and knowing what it does, the business model, the different products and services, because I think everything else just flows from there. If you really put the work in to understand the business, you can get an edge.

Kate:
Sounds pretty important to me. What about you, Kev?

Kevin:
Yeah, just further on to Cathryn's point, it's all about the business and the business model for me. Making sure that you actually understand it, and it's not just three letters on your screen, or four letters on your screen, we're really looking into the business and how does that business model scale and grow?

Kate:
I think that's probably an important thing that a lot of people have to learn. Instead of just going, "Hey what stock code do I buy?" It's actually what does this company do? I think we can often get a bit distracted when we're looking at forums of just like what's the hot stock code to buy? Rather than actually looking at what are some good businesses.

Owen:
Yeah sure, to Kev's point, if you just look at companies, or if you just look at things on your screen and you think that TLS which stands for Telstra shares, is just like a thing that's on your screen and it's not actually attached to a business, the longer you think like that, the greater your chance of losing money in investing in my opinion, so you've got to differentiate between that. And as Cathryn said, understand what the thing is behind that three letter symbol.

Kate:
Awesome, all right, well I think we'll kick it off with our first listener question from Alex which was all about share investing jargon. There is quite a bit in this industry, so Alex was overwhelmed by all the jargon about how a share is performing, and mentioned a few things like market cap, valuation, price, price to earnings and we've mentioned a few of those things, but I thought it'd be really good if we dissect each of those terms. So Kev, can you kick us off with what does market cap mean?

Kevin:

Absolutely Kate. We've all been there as well, all starting out, and it's like reading a foreign language right, we start off and there's all these terms, and then they've all got these acronyms and you're just like, "Oh it's a bit overwhelming." What I suggest is people take the time and slowly one by one start to dig and find out and learn.

Kevin:
But going back to your question there, market cap is really quite a simple formula when you break it down, and if you can put it into plain English, it's really just the current share price times the total number of shares available for that company. To use a very simple analogy we can think about a company as an entire pizza, and then each slice is one share. So say for instance a slice of pizza is two dollars, and there's 10 slices in that pizza, well then it's two times 10, and that equals $20. Very simplified example obviously, but with these companies that we're talking about, say a share price for zero is like $120 bucks for example, and there's say a million shares, well you'd just do that simple formula again, that $120 times how many shares are on offer.

Kate:
Why do we actually care about market cap?

Kevin:
I think it gives you a really good gauge on exactly how big that company is in respect of the industry. For instance, you could be talking about a company like one of the big tech companies that just dominates the field, right. You're like "Wow, it's like a billion dollar company, or a trillion dollar company. How big is that industry?" So it's just good to see how they are, where they sit in the market and go "Are they a market leader, or are they somebody that's up and coming and is a disrupter to the industry?"

Owen:
Mm-hmm (affirmative), one of the things I might add there is that a lot of people new to investing think that Commonwealth Bank shares are $80, and Telstra shares are three dollars, that means that Commonwealth Bank shares are 20 times more valuable than, or 20 times better than Telstra, that is totally not the case. Going back to Kev's example it's not what the slice is worth, it's not what the slice of pizza is priced at in your account, it's actually what the total value of the thing is that determines how big it is.

Owen:
So you can have a company with a billion shares at a dollar, or you can have a company with 10 shares at $200. It doesn't mean that the one is that's $200 is the bigger company, it's totally not that, so you've got to actually focus on the total value of the company, and that's where something like market cap comes in.

Kate:
Then looking at share price versus valuation, we've talked about valuation in our share investing checklist, but when you're looking at your brokerage account you can see one thing which is the

share price, but then an analyst like Cathryn might actually think it's valued at a higher or lower amount, so are you able to explain what you should be looking at with share price and valuation?

Cathryn:
Yeah sure, so there's a famous quote, I think it's by the great Warren Buffett which goes something like, "Price is what you pay and value is what you get," and then put another way you could say, price is what you're asked to pay, and value is what you're willing to pay. So everyone's assessment of value is different, and typically we buy an item or invest our money into a company if value is greater than price. So share price is what you see in your brokerage account, but the value to you, depending on your assessment of value using different ratios or valuation model, might be higher or lower than price.

Kate:
And the share price for a company will just change depending on what people are willing to pay?

Cathryn:
Yes, totally, day to day of the market. Then in reality the value doesn't change nearly as often as it does.

Kate:
No, because the company's not just going up 100% because there was a good news article on it and everyone got excited.

Owen:
For example when we have recommendations for our companies, Kevin, Cathryn and I will get the latest quarterly report if it's a US company, or a half yearly or an annual report here in Australia and it's only at that time that we'll then go back into our valuation model and actually change things. We don't tend to change things everyday like you'll see in a share price changing every day.

Owen:
So if you had two lines on a chart, the price which is what you see in your brokerage account would be bouncing up all over the place, but the valuation would more look like just flat lines occasionally changing, moving up and down.

Owen:
When you get to a certain level of your investing, when you actually understand how valuation works, as well as its weaknesses because it has plenty, you can actually act in a more civilised manner, because your emotions aren't up and down one day to the next. I think that was a game changer for me, learning how valuation actually takes place, trying to apply that to every company that I follow.

Kate:
Mm-hmm (affirmative), and I thought I'd also just check in of what's everyone's favourite metric or number when they're wanting to have a look at the health of a company? What about you, Owen?

Owen:
Well as I said at the top of the show, it's got to be built strong, Kate. There are two things here, cash and debt, you can find both of these on the balance sheet. So go to the annual report, go to the statement of financial position, or balance sheet depending on how it's titled. You can just look, just like a mortgage, if a company has 100% of the value of its assets in debt, so if it's got a huge amount of debt and it's got a little bit of cash, that's not necessarily a bad sign all the time, but I always ask why. Why does it have that much debt?

Owen:
Then the second question is, can it sustain it? The types of companies that we invest in, I think all of us here, I think I speak for everyone, are companies that don't have a lot of debt. Because when interest rates rise, which they could in the next five to 10 years, I've heard having a lot of debt in investing has been described as trying to play poker with a set of cards in your hand and then sooner or later the creditor, the person that provides the debt, can all of a sudden just come along and rip the cards out of your hand, and then you're left with nothing to play.

Owen:
So debt is often one of those things that in the good times it works really well for companies and in the bad times, it's catastrophic. As a first point of call, that's where I go.

Kate:
What about you, Cathryn?

Cathryn:
Following on from Owen, I really like the cash and debt thing, not a thing, but the balance sheet is generally where I would go first. But another thing is the cash flow statement, so Owen said at the top of the show cash is king, you can book all the revenue that you want, but you have to see that eventually turn into cash, because that's ultimately what's going to sustain the business.

Cathryn:
In the cash flow statement, it's generally split into three sections, so you've got operating cash flows, investing cash flows and finance cash flows. Usually you could just focus on the top part at the start, so just operating cash flows, and ideally you want to see that positive. So the bottom number when they add up, out flows and in flows, you want to see a positive number, because it means that the company can sustain its operations.

Kate:
Sounds like you've got to know a little bit of accounting to do all of this.

Owen:
Well it does seem like that, but it actually isn't all that hard. Once you've done it once, you've done it many times. The operating cash flows right, the trickiest thing in my opinion is knowing the difference between cash flow and profit. Cash flow is what's on the cash flow statement, and profit is what's on the income statement. That might sound like a bit of whatever, more jargon, but the reality is a business cannot make a profit, but be cash flow positive. So you can have a company that makes a lot of cash, but people think it's not profitable and so that's kind of your insight.

Owen:
But to Cathryn's point, just go and read the cash flow statement, see how things fall down, and it's just like positive, negative, positive, negative, and it just adds up at the bottom. If it's positive that's a good thing, if it's negative then you've got to ask why.

Kate:
I remember you did an analogy about having your income coming in from your job, and if all the money's just going out with expenses, you don't have much profit left at the end of the day, you might have a $100,000 income, but if you've got a lot of mortgages and private school fees to pay, you might not have much left at the end of the day.

Owen:
Exactly, and don't get me started on private schools.

Kate:
All right, and Kevin last but not least.

Kevin:
No worries Kate, just following on the team's top picks, mine would be looking at that cash flow and then going how does that relate to that top line growth? What we're talking about there is just that sales. I'd probably classify myself more as a growth investor, but I really do see them as growth and value as very similar things. Because if a company is a good business and it can't actually grow its revenues, well then you can't actually grow too much in the future, because you're only really then looking for efficiencies in the business model, you couldn't cut expenses and whatever. But if that business can't actually grow to another store or another country, well then it makes it very limiting in that company's future and that future outlook, so that's something that I look for.

Owen:
So top line is another word for revenue or sales?

Kevin:
Correct, that's right.

Owen:
And why do they call it the top line?

Kevin:
Because it's at the very top of the list.

Owen:
Yep, so listeners it is at the top of the income statement. The income statement is the first thing that you see when you look at the accounts, and it is the top line item, so that's why we call it the top line, so you want to see that growing, right?

Kevin:
Yeah, absolutely Owen. Again apologies for all the jargon, but we'll slowly dig through all these little terms and get some clarification on all of that.

Owen:
No, that's good. But that's good, it introduces people to the way we speak, right? So it's really important, because you're going to face that when you read an article and whatever. Kate, back to you.

Kate:
Makes analysts feel a little bit better about themselves having their own special jargon.

Owen:
Yeah that's it, it's code.

Kate:
Anyway, okay so the next question from Megs was all about buying your very first shares, so she wrote in saying, "I would like to buy my first lot of shares. I've got $2,000 to invest and just cannot decide on what to invest in." She's been reading and researching and is just going around in circles. Any tips or suggestions?

Owen:
Yeah, so I'll field this one. Megs, this is a great question, fabulous question and it's actually the topic of our next episode, so next week you'll actually get to hear where the four of us would allocate some hypothetical money if we did. Keep in mind, Megs that when we answer these questions in the show, we are experienced investors and your risk tolerance will be totally different to ours. But if I could just say something here, there are over 2,000 shares on the ASX, that's the Australian Stock Exchange, and that's just three percent of all the companies in the world that you can invest in on stock markets. It's easy to get decision paralysis.

Kate:
There's a lot of choice.

Owen:
It's not just three versions of baked beans, there's like 50,000. We understand it can be very confusing. You mentioned going around in circles, Meg I would say go to the centre of your circle, which is your circle of competence. This is something that we talked about in a previous episode, and Kate produced a share investing checklist, it's just a PDF that you can get in the show notes to one of the episodes that we just recorded. Download that PDF, fill it out, as you find a company and as you work through your investing, fill it out and try and identify the companies that you like and the companies that you don't like, and that will be a guide.

Owen:
There's one other thing that I wanted to add in here which is the first three years of investing is an apprenticeship, and it's an apprenticeship by fire. You will lose money, everyone listening to this will have lost money, and if you haven't, you will very soon, don't you worry, and that's okay. The key is learn from your mistakes, that's the number one thing to remember, learn from your mistakes, learn from your successes.

Owen:
I find it very, very concerning when people have a lot of success early on, because what happens is you have a lot of success and then you think that you have found the answer, you are the wunderkind and you are the greatest investor that's every lived. Then all of a sudden you parlay your money and you make a bigger bet, based on something that you've just done because you think it works, and then that bigger bet becomes a bigger mistake. The important thing is to start, learn from your mistakes, make lots of mistakes and make them small. The quicker you do that, the quicker you'll learn to have a lot of humility in your investing.

Owen:
If I had $2,000, Megs this is only my general thoughts, I'd break it up. I wouldn't put $2,000 into one thing. I'd put $500 in the company or the industry that you know the best, a big company, a safe company, and just see how it goes. $500 maybe do it this month, maybe $500 next month or maybe $500 in three months and just get used to the feeling of having money at risk, because it's going to be pretty turbulent at the beginning. But the hardest part is starting.

Kate:
Yeah, and I think you also mentioned recording all of the decisions you make along the way.

Owen:
Oh yes, yes.

Kate:
We talked about that a few months ago now, a decision making episode, using a Google Doc to record your thought process, because over three years as you learn more and you go through our free valuation courses and listen to different podcasts, you'll learn a lot that will change the way you think about investing as well. So I think writing them down, even if your very first

decision is just, "Hey, someone recommended this to me," it's good to actually note that down. So if it does well, or doesn't do well, you can see what led to your decision making process.

Owen:
So say it's a three year investing apprenticeship if you like, the only way to speed that up is to actually take stock of everything that you do. I know Kevin's doing this a lot lately, is actually writing out why he buys something, which is super important. Even if you listen to a podcast, write down some notes, use the same Google Doc, because it crystallises the wisdom that you get. So, listen to those around you and then take notes, interpret it into your own words. That is so powerful, a lot of great investors have blogs, the world's best investors are brilliant writers and it's not a coincidence, I say that so many times. Warren Buffett is probably one of the greatest writers I've ever read, and he's an investor first and foremost. Morgan Housel who we've had on the show, probably my favourite writer in the world, doesn't invest in stocks, but invests in ETFs. So those are just some of the things you can do, but a great question, stay tuned for next week, Megs.

Kate:
Yes, next week's episode is going to be a lot of fun. All right, next question from Tim is all about picking safe, I say that in quotation marks, blue chip stocks. Now, we haven't talked about blue chip stocks often on the podcast, but I'll just read his questions, and then I'll see what you guys think. So, Tim's a beginner investor, he's been doing a lot of reading and listening over the last six months, and really enjoys the podcast, which is fantastic. He just wants his first investment to be in a lower risk profile, and wants to invest in a blue chip stock with a long term view, he's thinking 10 to 20 years. He just wants to know how to analyse and chose the right one for long term growth. He's had a look at the checklist, but a lot of the companies he's looking at are large, well established, and they run and they have successful products and services. How does he go that step further, dig deeper, and actually differentiate between them, because he wants to choose a company with a decent return and a good dividend for compounding growth.

Owen:
It's a great question, Tim. I think we all would love that to be honest, so you've hit the nail right on the head. Dividends and growth, the holy grail I've written here. So there are only two reasons that anyone should buy shares in my opinion, that's to make income from the investment, so dividends, and the other one is for growth, as Kevin talked about before.

Owen:
So when we talk about growth, we're not necessarily talking about the growth in the share price, which is what a lot of people do, even some professionals confuse growth in the share price with growth in the actual business. We're talking about the business, so sales which is the top line, revenue, profit.

Kevin:

All the fundamentals there that we want to look out for, Owen. We're really looking for the company to actually perform, not the share price to perform. We think that, that will follow after the company actually performs.

Owen:
That's it, so if we get a company that's growing at 20% in terms of its sales, every year it's selling 20% more, eventually we would expect that to have a higher share price. It might not have it straight away, but maybe in five years, or 10 years it does.

Owen:
So typically, I just want to make a mention here of income. When we talk about income from dividends, they are typically most common with larger companies, because the reason a dividend gets paid, in my opinion, is that the company itself has chosen not to take the profit that it made that year and put it back in the business for more growth, it's actually chosen just to send that back to shareholders who benefit from that.

Owen:
So, we're typically looking for companies that don't sent that money back to shareholders, they're the companies that take that profit from last year and reinvest it back into the business next year, or this year, for further growth in the future. Those are the two things you look for in investing.

Owen:
Cathryn, I'll ask you a question.

Cathryn:
Mm-hmm (affirmative).

Owen:
Just to answer Tim's point here, is when you're trying to differentiate between companies and learn about them in the first place, I guess what are the sources that you would use to learn about companies?

Cathryn:
Good question. I think my first port of call is generally the company website, so just reading what it does, the different products, services, things like that. Then after that, you can go into the annual report, it's another primary source, the segment information, so you can see the different revenue lines, the different products or geographies it sells in. Another good one is a prospectus, which is probably one of my favourites, makes things really easy.

Cathryn:
When a company first lists on the ASX, they have to send out what's called a prospectus to prospective shareholders for the IPO, and it just contains everything you'd want to know really. So what it does in really fine detail, industry dynamics, competitors, market forecasts and all

sorts of things. Other than primary sources, other good things are articles or blogs from other investors just to get a different opinion, and also a website like Strawman which is a similar platform.

Owen:
Yeah cool. You mentioned a few things like segment reports, that's part of the annual report, which is obviously issued once a year, or annually. In the US, it's called a 10-K, so the 10-K report is also issued annually and you can download those from the investor relations part of their websites, or you can go to, is it EDGAR in the US?

Kevin:
That's right, the SEC website.

Owen:
Yep, the SEC website. It's horrendous, but you can get the 10-K from there. In Australia, you can go to the ASX website and you can get the report from there.

Owen:
I would just say, you say that many companies sound similar, and they are. Many companies like ANZ, which is a bank versus Commonwealth Bank, they're both banks. My opinion is you've got to find out why someone would go with one bank and not the other, or why someone goes with this product and not the other. So you can go on forums online, hear from management, watch YouTube video reviews, whatever it is, just find out.

Owen:
Kev, I might throw to you for this part. How did you find out about your first investment? Were you weighing up all the investments you can make? What did you do?

Kevin:
The very first investment that I actually made was way back in the day, probably over 10 years ago now, and they were actually very safe, simple businesses that I could touch and feel and that I used. Like a lot of people in Australia started off with bank shares, and back then I wasn't an analyst, I wasn't really even an investor, I just was somebody that was interested in shares and thought, "Oh, this seems like an okay business. It seems like a lot of other people like my parents and other people, friends and family, have owned bank shares." I thought, "Why not try and buy some shares and just start learning?" So, that was my very first experience. I think Owen loves me, loves me to bring up this story.

Kate:
I'm glad he loves you.

Owen:
Yes, I do.

Kevin:
Loves me to bring up a story about one of the businesses that I own, and that's called MercadoLibre, so the ticker code for that is MELI, it's listed in the States and that company is a company that I found when I was travelling overseas, and I was backpacking throughout Latin America and this is probably about six or seven years ago now. The big tech companies were really starting to flex their muscle and really get embedded into people's lives. What I saw in the States before I went to Latin America was how much people were using Amazon, and how much people were using Ebay. MercadoLibre is almost like a hybrid of that, and they've got a payment services business in there as well.

Kevin:
When I was down in Latin America, there was hardly any internet, there wasn't much e-commerce or anything like that, so it's a bit of a mix between Amazon and Ebay, and I thought as this continent develops, as the technology develops I think people are going to be using this service and the convenience of online shopping more and more, so something that I sort of latched on and got pretty lucky there.

Owen:
Basically you saw the opportunity, people would be using this in the future as the internet rolls out. There were case studies of things that have gone before, so that's a clear value proposition for potential consumers and potential customers, right?

Kevin:
Yeah, it was just, I think some of the countries, they were just starting to get a little bit of traction so they were getting in there and some people were buying things online, they're all the early adopters. I think everybody remembers the first thing they bought online and it was like, "Oh this is kind of exciting, but also kind of scary. It's like is it going to come? Is it not? When's it going to come?" But then slowly as these businesses get scale, they start to offer cheaper prices, more convenience, and I thought that was a really big tail wind for this company.

Owen:
Cool.

Kate:
It's interesting, I think we just have to keep in mind that ideas don't just come from trawling through forums or Twitter or the internet. If you have your eyes open when you're in the world, you can actually see a lot of great businesses that way.

Kate:
You mentioned bank shares, I realise that we probably didn't actually answer the question of what is a blue chip company. So if you haven't heard of that acronym before, Kev what is a blue chip company, the way we use that terminology in Australia? And, a few examples maybe.

Kevin:

It's probably the companies that are super safe, super reliable and make up usually a very large portion of people's portfolios, or holdings. We're talking about things that are really dependable, like businesses that everybody uses every day, their business models work, they make money and they might not go up 100%, or 50% every year. I like to use that cricket analogy where they're hitting singles every single year, rather than going out and trying to take on the world in a 2020 match and trying to hit sixes and fours, because every time that you swing out on that, it just doesn't have that consistency.

Kevin:
Looking at a compounding calculator, it's those guys that can really hit singles year on year and deliver that solid growth every year, because that base slowly builds and in five to 10 years, you've got a company that's worth quite a lot.

Kate:
So in Australia examples of blue chip would be?

Kevin:
I think most people would probably refer to probably the big four banks, maybe the supermarket giants, Woolworths, Wesfarmers, maybe even some of the big miners as our country is really built on, especially the west of the country, is built on BHP and Rio Tinto, so I'd say probably those companies would be what people would be referring to.

Kate:
All the companies that have given the retirees in Australia great portfolios over the last 30 years or so.

Owen:
Dividends.

Kate:
Dividends and franking credits.

Owen:
Dividends, blue chip, franking, yep. Not blue ribbon, people confuse blue chip with blue ribbon.

Kate:
Do they?

Owen:
Trust me, it happens. Cathryn you're looking at me funny, but people say blue ribbon, I think that's an ice-cream.

Kate:
It is an ice-cream.

Kevin:
A very delicious ice-cream.

Owen:
Cool.

Kate:
Did you have anything else you wanted to add to that question, or do we move on?

Owen:
No, I think that's about it. We put safe in air quotes because even though we talk about blue chips and we talk about being sensible, remember that the share market is a layer of emotion that sits between commonsense and your investment portfolio, and that emotion is driven by other investors who may not be as rational as you. Even though a blue chip like CBA is going to pay dividends most years, there are some times when CBA shares will fall, and that's okay, just keep an eye on the business.

Kate:
And safe in the past doesn't mean safe in the future.

Owen:
Yep, just look at any of the big photo companies like Kodak. Where are they now? They were blue chips once, right? So, keep that in mind.

Kate:
Awesome. The next question was from Jarrod about paying tax on shares. I've got a question on paying income tax on share growth. Say you have a share portfolio worth a million dollars, that'd be pretty sweet. You have 10% growth that year, which would also be great. You'd then have to pay 30 odd grand in tax, is that right? How am I supposed to afford that without selling some shares and then incurring capital gains tax?

Owen:
Okay, let's just unwind that maths quickly for all listeners.

Kate:
Yeah, I think we need to.

Owen:
So, Jarrod is saying if you had a million dollars invested, it went up 10%. So that means from today until a year from now it went up 10%, or $100,000 and he's used the example of a 30% tax rate. So if you made $100,000 growth in this question, do you pay $30,000 of tax, which is 30%? The answer is no.

Owen:
You don't pay capital gains tax, which is the increase in your investment on shares until you sell. So, this is one of the big advantages of being a direct share investor, because you can control when you buy and sell. Unlike when you're in an ETF or in a managed fund, that's not up to you, that's up to someone else. Typically, it's built on rules or the fund manager's decision making. So, this is one of the advantages of being a private investor in individual shares.

Owen:
So there are two types of taxes you pay typically in Australia, which is income tax on dividends and you have capital gains tax when you sell. One of the massive advantages for long term investors over traders, people who have a short term focus, is that after a year of holding an investment you only pay capital gains tax on half of the gain.

Owen:
So in this case, $100,000 increase, if you sold it in one year and one day, your 30% tax rate would only apply to $50,000, so you're paying 30% of $50,000, not 30% of $100,000.

Owen:
So, this is a decision you have to make when you are investing for the long term, is people say, "Oh well, it's hit my valuation. My CBA shares are now at my valuation, so I should sell." Well there are two things you need to consider, one, where do you put that money once you sell? Even if you made a gain, where do you invest it? Do you have another idea? Two, does that new idea outweigh the cost of paying tax? Because, if you sell you're going to have to pay the tax on the gain.

Owen:
So, oftentimes I think all of us in this room are extremely long term focused for this reason, well not just for this reason, but this is one of the big benefits, right? Maybe I sell one or two shares a year, that's the reality, it's not because I hate tax, it's because I prefer to let great companies do their work. Does anyone else have any insights on this?

Kevin:
I think great businesses take time to really build out that advantage, and to really get stronger and stronger. I think if you're selling a great business which early, and I've been guilty of this many times, is you think "Oh, the share price has gone up so high, I might take some profits." But I probably regretted that decision for every strong business that I've owned, because if the business model works, if everything else lines up, and the management are really competent and executing well, well that horizon and that runway is actually very, very long.

Owen:
Don't just not sell because you're going to have to pay tax.

Kate:
Mm-hmm (affirmative).

Owen:
You'd rather share 30% of the profits with the ATO than cop 100% of the loss if it falls. Don't necessarily just avoid selling because you're worried about tax, that's just an inevitable part of investing. Good question Jarrod, and if you need any more information you can go to our website where we've got information on capital gains tax, income tax and everything like that.

Kate:
It's good to be able to differentiate between the two.

Owen:
Yeah, that's it.

Kate:
Otherwise, you might be really worried about paying tax when you don't actually have to pay any because you haven't made a sale.

Owen:
That it, cool.

Kate:
Awesome. Okay so the next question from Zack is about mergers and acquisitions. That's another thing I know we haven't actually spoken about on the show before, so it was good to get this question. Zack asked what happens to shares held in an individual company if that company goes through a merger or is acquired by another company?

Owen:
So mergers and acquisition, what do those two words mean? Six of one and half dozen of the other, Kate. It is the same thing, so a merger and an acquisition is effectively the same thing for your investment. A merger is when two companies come together. An acquisition is when a bigger company typically overtakes a smaller company.

Owen:
So if McDonald's wanted to buy, wanted to own KFC, then they go and buy the KFC brand, that's an acquisition. Or, if they came together and they worked harmoniously you might call it a merger. But basically it depends on what's being offered and the way you find this out is when the acquisition or the merger is announced, if your company is being taken over, go and read the document because it will tell you how much the acquisition, so if your shares are a dollar, there's an announcement that it's going to be what they call a 50% premium, it might mean that you're going to get 50% more than the shares were worth yesterday when the acquisition goes ahead. Go and read the documents and it has all of this detail.

Owen:

It's announced to the ASX, so you can find it on the ASX website, it might be mailed to you, or you can find it in the news section of your shareholding. Go and find out what exactly the details are, because there are two ways an acquisition is typically paid for.

Owen:
Imagine, Kate Limited, my company is going to buy Kate Limited, so Owen Limited is going to buy Kate Limited.

Kate:
Mm-hmm (affirmative).

Owen:
I make an announcement, and I say I'm going to buy you, you have to disclose that to the share market and I say in my announcement, and in your announcement, we're going to say I'm buying your company for cash. Then the other option is, instead of giving you cash, I'll just give you shares in my company, so we'll absorb your company but we'll give you shares instead as a core consideration. So Kevin, I might throw it to you, mate. Can you explain what happens when a company doesn't pay cash, so it's paying with the shares or scrip.

Kevin:
Basically what happens is the value of the company, say if it was 10 million dollars or whatever, then they would give you shares that are worth that 10 million, or whatever premium there is, if there is a premium on the takeover. That just means that if the company really wants the smaller company, then they might pay overs for that.

Kevin:
Then what they will do is instead of giving you cash for that, which Cathryn will explain in the next example, they'll give you shares. What they'll do is they'll give you, for instance, going back to that Owen Limited and the Kate Limited example, is Kate would get Owen Limited shares instead of cash for the business. It just means that there's no right or wrong here, some people like to own shares in the bigger business after, some people prefer cash, that's a very personal decision. But with investing you've always got options, and usually with a takeover or a merger or an acquisition, there's usually a chance there where the share price already has moved close to the acquisition price, and you can actually sell out if you don't want shares in the new company.

Owen:
You're right, so say if an announcement was made that there's an acquisition taking place of $1.50, typically what happens on the share market the day that it's announced is the share price goes towards $1.50, right?

Kevin:
Correct, maybe like $1.40 or $1.45 or something like that. You might not get the exact full amount, but there's also uncertainty whether or not that deal actually goes ahead, and usually

that could take months. What a lot of investors do is they go, "I don't want to own shares in the new company, I've got a pretty good price for my shares, and I can sell out right now."

Owen:
Waiting for the acquisition to take place, you could just sell your shares in your brokerage account after they've jumped.

Kevin:
Correct. Or, you could wait and do nothing and then wait for all the docs to come through, wait for the offer to be finalised, and then what will happen is you will just get issued new shares, your old shares in the existing company will get cancelled, and then after a while the new shares will appear in your brokerage account.

Owen:
The thing is, the deal might not go through, there's a risk that it doesn't go through. You can choose to sell immediately and take your gain, but that's totally up to you in your assessment of what's going to happen. How about, Cathryn, what happens when the deal is announced and the deal is funded by cash?

Cathryn:
It's probably the more common of the two approaches, cash. It's usually when say like an overseas company is acquiring an Australian company, or it's a private equity, so they often offer cash. In all the announcements in the documents they'll say we're going to acquire, for example, Coca Cola Amatil which was an ASX company until, I think it was this year, got acquired by the US big giant. But it will sort of say, "We're offering to buy this company for X amount per share." Generally it has to go through a lot of regulation, shareholder approval, but after say a few months, then if it goes ahead, then that money will hit your bank account I believe, I don't think they send cheques anymore.

Owen:
Yep.

Kate:
Not that I've heard of, but you don't really have a choice, if you don't sell you just ...

Owen:
Yep.

Kate:
I know my Nan was always frustrated when she thought she should have a choice as a shareholder that if there was a takeover she should be able to reject it, but they don't really care about the tiny shareholders.

Owen:

Unless there's a vote which is, it happens, but you have to make sure the big shareholders want to make the same decision that you do and vote the same way. Because, if you've got 0.0001% of the company you don't really have much sway. Just make sure when any of this stuff happens, as with anything we've talked about before, just make sure that your brokerage account is updated, and the share registry, the company that manages your shareholding, which might be Computershare, Link Market Services, Boardroom, any of those companies, that they've got your tax file number and they've got the correct bank account details.

Kate:
Sometimes there's a few more tax considerations. I know there was some more complex take overs and mergers in the recent years that investors had to work through this whole PDF document to work out if they had this, then what is their value now, what is their cash base, and it can become a bit more challenging.

Owen:
There was an example of Westfield, which many people know is the shopping centre giant, that was bought out by a company called Unibail-Rodamco, that's an overseas company, right? But they wanted to offer the Australian Westfield shareholders shares in the new company, the combined company. I think UBW is the ticker code?

Cathryn:
URW.

Owen:
URW, makes sense, URW. They listed a version of those shares on the ASX, the Australian stock market, so you could get exposure to the company that you once owned, which is Westfield. But it was a complicated transaction, because it's an overseas company acquiring an Australian company that was then going to list its shares in Australia for Australian investors and they're linked to overseas shares. So it gets very complicated, but basically the company does a very good job, they have to do a very good job of explaining exactly what you stand to gain.

Kate:
And I just think, especially in that case, for some people it was a lot more hassle than it was worth to hold onto the Australian version of shares. I think you had to pay your tax in France or something on the income.

Owen:
Yeah, there's some weird stuff that goes on, it's all in the docs, just take a look.

Owen:
Some people love acquisitions, because typically what happens is the only way the deal goes ahead is if the offer to buy the company is at a higher price. But I often get really frustrated because I, and we, tend to invest in companies that are growing really good companies. Then even if a company, a big company comes along and buys them out for 50% more than the

shares were worth yesterday, sometimes I'm annoyed because I think this company is going to be worth 10 times that amount in 10 years. But we don't have a choice, we just have to accept that, that's the money that we get, and we have to pay tax on the gain, back to the question beforehand.

Owen:
So acquisitions can be good, but I've had it too many times when my companies have been bought out, I don't know, maybe we're doing something right.

Kate:
All right, so final question for today's episode, a question from Siew-Lee, using external analysis tools, so asking any thoughts on using tools like Simply Wall Street to assist in your share analysis? I don't know if you guys use any external tools like this?

Kevin:
Yeah, we definitely do. But going back on the first thing, and it's a great question by Siew-Lee, is we often talk internally about this concept that we call Mosaic Theory and it's really just think about it as like a big wall as our investment thesis, and every piece of information that we get is just a little tile that we put on that wall. So it's important not to get too fixated on one specific element, or one specific fact.

Kevin:
What we believe is when we do the work, when you're learning about the business, when you're learning about the company is every piece of information that you get is one little tile that you can put up on that wall. Then hopefully over time, whether that's weeks or months or even years, you start to add piece by piece of information.

Kevin:
I think a lot of these tools that are quantitative and what we mean by that is just really dealing with numbers and hard facts is it does help you understand the business, but it's not the complete picture. It might be one part of the wall, or one part of the mosaic. Our style is really more of a bottom up approach and looking at fundamentals of the business, and we're really digging into the business model and going how does this business make money? What do their customers think about it? We think that's where the real gold is, and we're looking for that quality side and how we can actually articulate that quality in the business.

Kevin:
We think that, that accompanied with that long term investment horizon and with time on our side, that's the biggest advantage that we have as investors.

Owen:
So, I know the guys from Simply Wall Street, and I know them pretty well and I think what they've created is brilliant. They're a really smart group of engineers.

Owen:
Personally I don't use the Simply Wall Street platform, like Kev said, I go straight to the source documents, or try to find all of the things that I want to find out online. Because I think they're a million brokerage accounts in Australia now, so that means that there are a million investors who have the same set of information, globally there would be many, many millions, probably hundreds of millions of investors. If you have the same information as hundreds of millions of people, what's your perspective, and how is it different?

Owen:
If everyone has access to the easiest things, then everyone is going to make decisions based on the same things. So we're trying to find the information that no one else has, without it being insider information, which is illegal of course, we're looking to piece together that mosaic quicker than anyone else by using things that no one else can see, or few people can see. So to Kev's example, like imagine that old, the draw between the lines, you'd draw this line to that point from that point.

Kate:
Connect the dots?

Owen:
Connect the dots, that's the one. What am I thinking? Lines? Connect the dots, imagine that if you zoomed out, it actually is a picture of an elephant, right?

Kate:
Mm-hmm (affirmative).

Owen:
We're trying to work out that, that is actually an elephant before we've connected all the dots. And the quickest way to find out before everyone else is to use different information, so we're looking for different things. Tools like Simply Wall Street are great, because they help you avoid, a bit of slang here Kate, they avoid waking up feeling like a wet towel. I think that's the saying?

Kate:
Hung over like a wet towel.

Owen:
Hung over like a wet towel, there we go. I stuffed it up.

Kate:
You stuffed it up.

Owen:
But okay, so you don't want to wake up feeling hung over as a wet towel realising that you shouldn't have bought a company because it's got a huge amount of debt. Or, that it's not

growing as fast as you thought it was, and the easiest way to get insights like that is to use tools that help you just spot things really plainly and simply.

Owen:
So you can use a tool like Simply Wall Street as part of your filter or your checklist. So you could say, "I don't want to invest in any companies with lots of debt," then you could go on to Simply Wall Street, or you could go onto many of those platforms, and you could say, "Give me a list of companies that don't have debt," and then you can start your research from there.

Kate:
Mm-hmm (affirmative).

Owen:
I think that's a great way to build filters and checklists and start your research. But to Kev's point, and sorry for the long, waffly answer on my end, is oftentimes you've got to do the work yourself, or rely on someone who's done the work and you trust. Anyhow that's what we kind of do. Simply Wall Street, made by Al Bentley and his team, they've got a free account if you want to go and check it out.

Kate:
Mm-hmm (affirmative), and I think you've interviewed them on the Investors podcast before?

Owen:
Yeah, I spoke to Al on the Investors podcast quite a few months ago. You can find out how he built that business, all the things that they do behind the scenes and the vision for it. They would have to have over three million free users now with free accounts, which is huge for an Australian company. We wish Al and his team all success in conquering the world. So cool, great question Siew-Lee, it's a really popular tool and you can find out more on their website I guess.

Kate:
Awesome, does anyone else have anything they want to add before we wrap this show up?

Owen:
Kate, what's your number one pick, stock pick?

Kate:
Oh, I think you're going to have to wait one more week for this.

Owen:
Geez, the cliffhanger.

Kate:
It's super wild.

Owen:
Okay, it's going to be a wild pick, we're promised, so that's a good one Kate, it's a good way to end the show. So listen in next week, we've answered your questions. Next week we'll have a hypothetical portfolio.

Kate:
Stay tuned.

Kate:
Thanks for tuning in to this episode of The Australian Finance Podcast where our mission is to improve the financial futures of all Australians. If you'd like to learn more, create a free account at rask.com.au/account to download free episode workbooks, bonus resources and take our amazing free personal finance courses.

Owen:
You can also join our online community by following the link in description. If you enjoyed the show, what we'd love is for you to leave us a snappy review on iTunes and you can follow us on Twitter and Instagram @RaskAustralia, Kate and I are also on both of those channels. Finally, if you have any feedback, suggestions for episodes or guests to come on the show, or you just have a question for us, shoot us an email at podcast@rask.com.au.