Market Outlook 2020 Presentation

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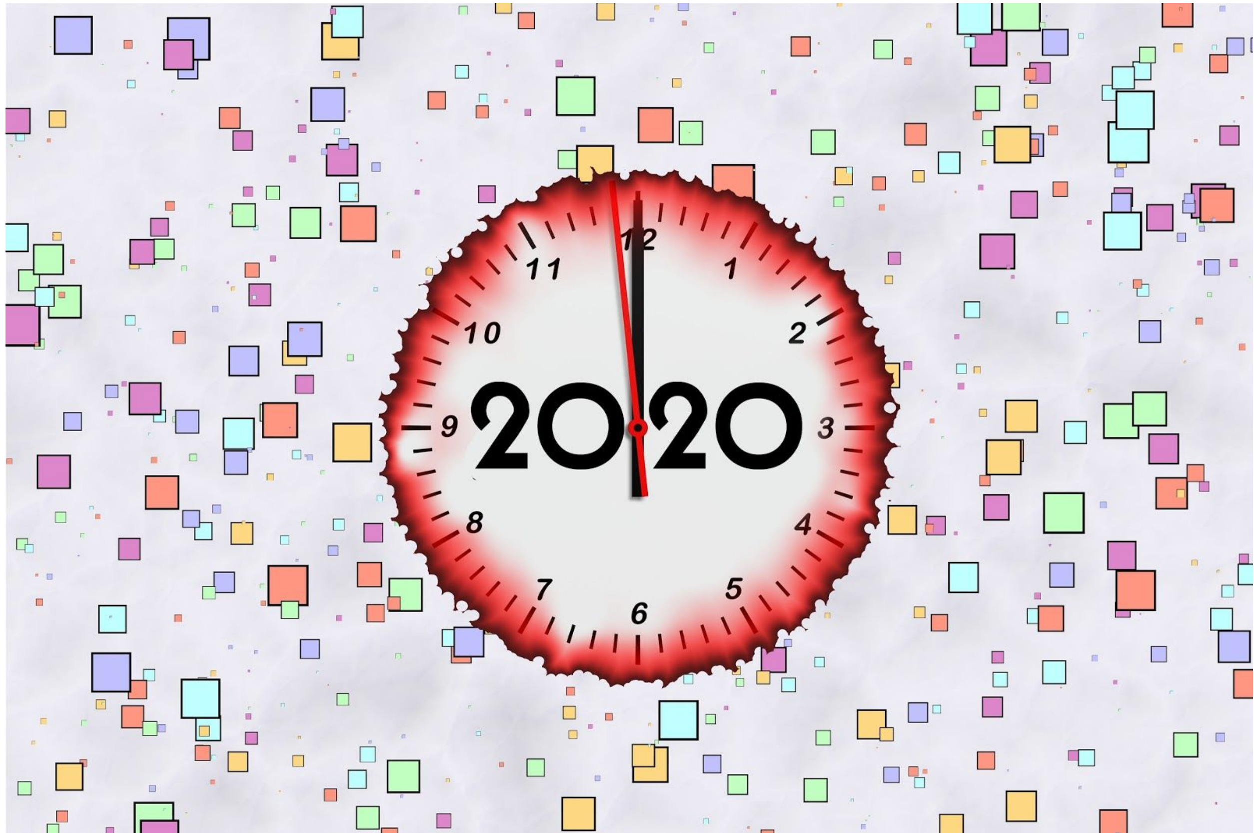

I gave two small-group presentations in December 2019 at the request of friends. The presentations were on the 2020 market outlook. I kept the presentations nearly identical too, since there were important things I wanted both groups of attendees to know, and I knew both events had completely different audiences.

I prepared a speech and a slide-deck for the presentations. ***They are meant to be viewed together****. You can* ***download the slide-deck here****. A PDF of the speech is found below; for the online version, you can* ***find it here****.*

Introduction

[Slides: 1 to 2]

Thank you for having me today. The topic of my presentation will be on the market outlook for 2020. Before I start, allow me to quickly introduce myself. I'm Chong Ser Jing. I joined the Motley Fool Singapore in January 2013 as an investment writer, and I became a co-leader of the company's investing team from May 2016 till my departure in October 2019.

Now I run an investing blog called *The Good Investors* together with my long-time friend Jeremy Chia. Jeremy and I are also in the midst of setting up an investment fund with the primary objectives of building wealth for Singapore investors through long-term investing in the stock market, and giving back to society.

So first, a quick disclaimer: Nothing I say tonight should be taken to be financial advice. The information I'm sharing is purely educational.

Big predirctions for 2020

[Slide: 3]

I'm going to start with my bold predictions for 2020. A warning though: It's ugly.

First, the US will go to war in the Middle East. It's unfortunate to see countries at war, but I see this happening. Second: The price of oil will spike. We know that oil prices started crashing in mid-2014 and have stayed low since, but do watch out in 2020. Third: The US will enter a recession. It has been a long, long time since the US has seen a recession, but I think it will soon. Fourth: Stocks are in for a rough time, according to Ray Dalio:

> "Unfortunately… the current economic climate of low inflation and historically slow growth means that bonds will actually prove to be the better long-term performers"

If you're unaware, Ray Dalio is the founder of Bridgewater, one of the largest fund management companies in the world. Bridgewater's assets under management are around US$160 billion today.

A confession

[Slides: 4 to 8]

Are you worried now? I have a confession to make. My predictions are *not* predictions at all. Let me say again: I'm ***not*** trying to make any prediction. I'm just stating *actual* events that happened many years ago in the past to make an important point.

The first and second "predictions" took place in August 1990. The third "prediction" occurred in July 1990. The last are comments Ray Dalio gave in February 1992.

How has the market done since 1990, knowing that the picture was bleak? Turns out the market has done very well. From 1990 to today, the S&P 500 has increased by nearly 800%, *without* even counting dividends.

Interestingly, the world has seen multiple crises in every single year from 1990 to today, as the table, courtesy of data from Morgan Housel, illustrates.

And that is the important point I want to make: **Uncertainty is always around, but that does not mean we should not invest**. This is one key takeaway for you from today's presentation.

Yes, the market has its ups and downs, but there's still a clear upward bias.

Market outlooks

[Slides: 9 to 10]

Okay, next I want to talk about market outlooks. I think it's a very important topic to discuss. We're at the time of the year where you'll be bombarded by market outlooks.

I want to play a simple game with you. Make a guess as to who will win in a contest of predicting the return of the US stock market every year. In one corner, we have the blue team, which consists of market strategists from the most prestigious financial institutions in the US. On the other side of the ring is the green team, with a sole member. This person is a simple guy who thinks the US stock market just goes up by 9% every year.

Based on real-world data from 2000 to 2014, it is the green team that wins. In that period, the blue team's forecasts were off by an average of 14.7 percentage points per year. For the green team, his forecast was off by an average of 14.1 percentage points per year.

This chart shows how bad the strategists' forecasts were, compared to the US market's actual returns. The blue bars are the forecasts, while the red bars show the market's actual performance.

Frequency of market crashes

[Slide: 11]

So I think no one really knows how the market is going to do next year. It could crash - or it may not. But one thing I know for sure: Market crashes are *common.*

Morgan Housel, again, provides great data. This table shows how often the US market has fallen by a certain percentage going back to 1928. We can see that 10% declines happen nearly once a year; 20% falls, once every two years; 30% drops, once every decade; and 50% collapses, two to three times per century.

Let's not forget that from 1990 to today, the US market is up by nearly 800% *despite* stocks having fallen by 50% or more, *twice.*

Morgan's data show that **it is *perfectly* normal for us to experience market crashes multiple times throughout our entire investing career**. This is another key point I hope you'll take away from my presentation today.

Why do crashes happen?

[Slide: 12]

You may ask, rightfully: Why are market crashes so common? For this, we have to visit the theories of the late Hyman Minsky. When Minsky was alive, he was an obscure economist. But his ideas flourished after the Great Financial Crisis of 2007-09.

That's because he had a framework for understanding why markets and economies go through ups and downs. According to Minsky, stability is destabilising. If the economy does not suffer a recession for a long time, people feel safe. This causes people to take more risk, such as borrowing more, which leads to the system becoming fragile.

The same goes for stocks. Let's assume that stocks are guaranteed to grow by 9% per year. The only logical result would be that people would keep paying up for stocks, till the point that stocks become too expensive to return 9% a year. Or people will take on too much risk, such as taking on debt to buy stocks.

But bad things happen in the real world. And they happen often. And if stocks are priced for perfection, bad news will lead to lower stock prices.

Feature, not a bug

[Slides: 13 to 15]

Let's play another game now. I'm going to share two stocks with you, and you're going to tell me which you would prefer to invest in.

Stock ABC is the first. It was listed in 1997. From 1997 to 2018, the peak-to-trough decline in Stock ABC's share price in each year had ranged from 12.6% to 83.0%. Put another way, Stock ABC had experienced a double-digit peak-to-trough decline *every single year* from 1997 to 2018.

Now let's look at Stock DEF. It was also listed in 1997. And the chart shows Stock DEF's share price growing by an astonishing 76,000% from $2 in 1997 to $1,500 in 2018. It's obvious that Stock DEF has been an incredible long-term winner.

With this information, would you prefer to invest in Stock ABC or Stock DEF? Here's the kicker: They are *the same stock.* Stock ABC and Stock DEF are both Amazon, the US e-commerce giant.

This leads me to another key takeaway for you: **Volatility in stocks is a *feature,* not a bug**. Even the best long-term winners in the stock market also suffer from sharp short-term declines.

Expect, don't predict

[Slide: 16]

Another thing I want to talk about is the importance of expecting but *not* predicting. We know for sure that market crashes happen periodically. But we don't know *when* they will occur. And the track record of people who give precise forecasts on such matters is horrible, to put it mildly.

So if we're investing for many years, we should count on things to get ugly a few times at least. This is different from saying "The US will have a recession in the third quarter of 2020" and then positioning our investment portfolios to fit this view.

The difference between expecting and predicting lies in our behaviour. If we merely *expect* downturns to happen from time to time, we won't be surprised when they come. Our portfolios would also be built to handle a wide range of outcomes.

If we're trying to predict, then we *think* we know when something will happen and we try to act on it. Our portfolios may thus be suited to thrive only in a narrow range of situations - if a different outcome happens, then our portfolios will be on the road to ruin.

How to prepare

[Slide: 17]

This leads me to the next logical question: How can we prepare our portfolios to thrive in a wide range of outcomes? I believe the answer lies in how we view the stock market by reasoning from 1st principles.

The first stock market was created in Amsterdam in the 1600s. Many things have changed since. But one thing has remained constant: A stock market is still a place to buy and sell pieces of a business.

Having this understanding of the stock market leads to the next logical thought: That a stock will do well over time if its underlying business does well too. Warren Buffett's Berkshire Hathaway is a great example. From 1965 to 2018, Berkshire Hathaway's book value (which is assets less liabilities) grew by 18.7% per year while its share price climbed by 20.5% per year. An input of 18.7% led to an output of 20.5%.

Growing businesses

[Slides: 18 to 19]

I have an investment framework that I believe can lead us to companies that can grow their businesses at high rates over a long period of time. I have an article on my blog, thegoodinvestors.sg, that explains my investment framework. I'll run through it quickly.

First, I want companies with revenues that are small in relation to a large and/or growing market, or revenues that are large in a fast-growing market.

The first criterion is important because I want companies that have the capacity to grow. Being stuck in a market that is shrinking would mean that a company faces an uphill battle to grow. Print-advertising is an example of a shrinking market - it has shrunk by 2.3% per year across the globe from 2011 to 2018.

Second, I want companies with a strong balance sheet that has minimal or reasonable levels of debt.

A strong balance sheet enables a company to achieve three things: (a) Invest for growth, (b) withstand tough times, and (c) increase market share when its financially-weaker companies are struggling during economic downturns.

Third, I want management teams with integrity, capability, and an innovative mindset.

A management team without integrity can fatten themselves at the expense of shareholders. A company can't grow if the management team is weak. And without an innovative mindset, a company can easily be overtaken by competitors or run out of room to grow.

We can look at a company's history to get a sense for the third criterion. Areas we can look at include (a) how management's pay has changed over time in relation to the company's business; (b) whether there are huge amounts of related party transactions; and (c) the company's past actions to grow its business.

Fourth, I want revenue streams that are recurring in nature, either through contracts or customer-behaviour.

I think this is a crucial trait in a company that many investors don't pay attention to. Having recurring business is a beautiful thing because it means a company need not spend resources to remake a past sale. Instead, past sales are recurring, and the company is free to find brand new avenues for growth.

Fifth, I want companies with a proven ability to grow.

Companies with a proven track record have a higher chance of being able to grow in the future. I'm looking for strong historical growth in revenue, profit, and free cash flow.

Lastly, I want companies with business models that give a high likelihood of generating a strong and growing stream of free cash flow in the future.

That's because the more free cash flow a company can produce, the more valuable it is.

I believe that companies that excel in all or most of these six criteria could be worthwhile investments for the long run.

But companies that excel in all six criteria may still turn out to be poor investments. It's impossible to get it right all the time in investing, **so I believe it is important to diversify**. This is another key takeaway for you.

Protecting the portfolio

[Slides: 20 to 21]

I've been using my investment framework for my family's portfolio for over nine years. In that period, I've managed to produce a return of around 18% per year without counting dividends. This is far ahead of the 13.7% annual return of the S&P 500 with dividends.

The investment framework also guided my investment process in my time at The Motley Fool Singapore.

I used my framework to help pick stocks from around the world for the company's flagship investment newsletter. We recommended two stocks per month, one from Singapore, and one from international markets, including the US, UK, Malaysia, and Hong Kong. The newsletter nearly doubled the global stock market's return over a 3.5 year period.

Some of you may wonder: How can the framework protect your portfolio? Let me be clear. The framework *cannot* protect my portfolio from short-term declines in stock prices. Market downturns happen from time to time. They are inevitable.

The framework protects my portfolio by guiding me towards companies with strong balance sheets, strong free cash flow, and high levels of recurring revenue. These traits should enable a company to survive tough economic conditions relatively unharmed. They might even still be able to thrive.

Putting the framework into action

[Slides: 22 to 23]

Now I want to quickly run through how I use my investment framework by discussing a stock I bought for my family's portfolio, PayPal. I bought PayPal shares three times, in June 2016 November 2018, and June 2019. The June 2016 purchase was at US$38, and I've done very well on that.

PayPal runs a mobile and digital payment work that spans the globe. It can handle transactions in more than 200 markets, and its customers and receive, hold, and withdraw money in a wide range of currencies. PayPal has other payment brands under its umbrella including Braintree, Venmo, and more.

The company was first listed in February 2002. But it was acquired by online-auction platform eBay only a few months later. Over the years, PayPal started to outgrow eBay. In mid-2015, eBay spun off PayPal as a new listing.

How PayPal meets the six criteria

[Slides: 24 to 32]

The first criterion of my investment framework is on PayPal's market opportunity. The global digital and mobile payments market is worth a staggering US$110 trillion. Moreover, around 80% of the transactions conducted in the world today are still settled with cash.

For perspective, the total payment volume flowing through PayPal's platform over the last 12 months is US$676 billion (or US$0.676 trillion). The company earned US$17 billion in revenue from this volume.

Next, is on PayPal's balance sheet. The company's balance sheet is rock solid with nearly US$7 billion in cash and just US$5 billion in total debt.

The picture may change soon though, as PayPal will be acquiring Honey for US$4 billion in the coming months. Honey helps consumers in the US discover discounts while shopping online. But I'm not worried, as PayPal has a solid track record in generating free cash flow, which I will talk about shortly.

The third criterion is on PayPal's management. In 2018, PayPal's leaders were paid mostly with stock awards that vest over three years; restricted stock awards that depended on the company's revenue and free cash flow growth over three years; and stock awards that are based on PayPal's share price movement over a five year period. The last factor is specifically for PayPal's CEO, Dan Schulman.

I think PayPal's compensation structure aligns my interests closely with management's. There is an emphasis on the company's free cash flow and *long-term* share price movement. Regarding the capability of PayPal's management team, there are two clues. First, PayPal's network has grown impressively since the separation from eBay. Transactions, payment volume, and the number of active accounts have all enjoyed double-digit annual growth.

Second, PayPal has been striking up strategic partnerships with many parties since the spin-off. The chart on the left shows the partners PayPal had when it was still with eBay - there were no partners! The chart on the right was shared by management in 2018 - there are *many* partners.

The fourth criterion is on the level of recurring revenue. PayPal excels here. Around 90% of PayPal's revenue comes from the small fees that it takes from each transaction that it processes. In the first nine months of 2019, PayPal processed 8.9 billion transactions from 295 million accounts. These are transactions that likely occur repeatedly.

It's also worth noting that PayPal has no customer concentration, as no single customer accounted for more than 10% of its revenues in the past three years.

Next, I'm looking at PayPal's ability to grow. The company's track record is impressive, with a strong balance sheet throughout, and growing revenues, profits, and free cash flow. From 2012 to 2018, revenue and profit both compounded at 18% annually. PayPal's free cash flow compounded at an even stronger rate of 28%.

I also think that PayPal's business exhibits a network effect, where its platform becomes more valuable when there are more users. I want to pay special attention to Venmo too, PayPal's

digital wallet. Venmo is highly popular with millennials in the US, and has more than 40 million accounts. The annualised revenue from Venmo has also exceeded US$400 million, double from a year ago.

Lastly, it's about PayPal's free cash flow. The company has excelled in producing free cash flow from its business for a long time, and has huge growth opportunities ahead. So there's no reason to believe that the company's ability to generate free cash flow will change any time soon.

PayPal's valuation and risks

[Slides: 33 to 34]

Now, let's look at valuation. I believe in using simple techniques for valuation. Since PayPal has been excellent in generating free cash flow, the price-to-free cash flow ratio, or PFCF ratio, is useful. Right now, PayPal's PFCF ratio is 34, which is on the high side compared to the past. But I'm always happy to pay up for a quality company.

Lastly, we also need to talk about the risks.

The payments market is highly competitive, with many larger players. For example, Mastercard and Visa processed *trillions* in transactions over the past year, much more than PayPal. Then there are fintech players and also cryptocurrencies all fighting for room. The good thing is that the payments market is so huge that I think there can be multiple winners.
PayPal's soon-to-be-expiring deal with eBay is a risk. But eBay's business is declining. And in the latest quarter, PayPal's overall payment volume grew by 27% despite the portion from eBay falling by 3%.

Since payments is a highly regulated space, there's also a risk of regulators stepping in and lowering what PayPal can take per transaction.

Then there's recessions. If they happen - and we don't know when! - consumer activity could be lowered. This could lead to lesser transactions on PayPal's platform.

The purchase of Honey for US$4 billion that I mentioned earlier is also something to note. It will be PayPal's largest acquisition to date. The valuation of Honey is also steep, at around 20 times its projected revenue for this year. I think the acquisition will work. Honey has 17 million users. It can strengthen PayPal's value proposition to merchants by telling merchants what shoppers are looking for.

The last risk is succession. PayPal's CEO, Dan Schulman, is already 61 years old this year. The good thing is, the company's senior leaders are younger - they are in their mid-fifties or less.

Conclusion

[Slides: 35 to 36]

I've reached the end of my presentation. I just want to quickly remind all of you the four key takeaways.

First, uncertainty is always around, but that does not mean we shouldn't invest. Second, it is perfectly normal for us to experience market crashes multiple times throughout our entire investing career. Third, volatility in stocks is a feature, not a bug. Fourth, it is important to diversify!

With that, I thank you for your time. You can reach me through my blog, thegoodinvestors.sg, or through my email, thegoodinvestors@gmail.com

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