# Market Outlook 2020

By Ser Jing

*Thegoodinvestors.sg*

(Prepared on 3 December 2019)

***Note:*** **This slide-deck is meant to be viewed together with its accompanying speech; you can find the speech here**

# Disclaimer:

*All information is provided by Chong Ser Jing. Any information, commentary, advices or statements of opinion provided here are for general information and educational purposes only. It is not intended to be any form of investment advice or a solicitation for the purchase or sale of securities. Before purchasing any discussed securities, please be sure actions are in line with your investment objectives, financial situation and particular needs. International investors may be subject to additional risks arising from currency fluctuations and/ or local taxes or restrictions. The information contained in this publication are obtained from, or based upon publicly available sources that we believe to reliable, but we make no warranty as to their accuracy or usefulness of the information provided, and accepts no liability for losses incurred by readers using research. Content, information, commentary and opinions are subject to change without notice. Please remember that investments can go up and down, including the possibility a stock could lose all of its value. Past performance is not indicative of future results.*

# My big predictions for 2020

- The US will go to war in the Middle East

- The price of oil will spike

- **<u>The US will enter a recession</u>**

- **Stocks won’t do well**:
  *“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”* - Ray Dalio

# Actually…. they happened in the PAST

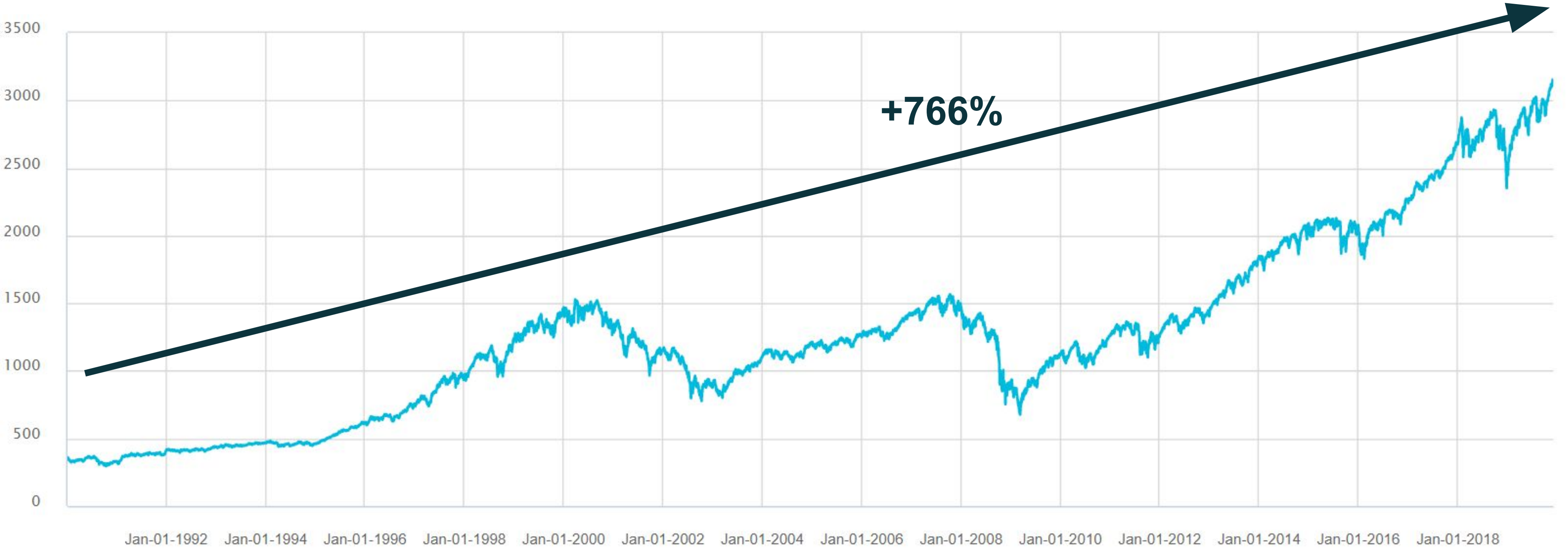
- The US will go to war in the Middle East ➔ Happened in August 1990

- The price of oil will spike ➔ Happened in August 1990

- **The US will enter a recession** ➔ Happened in July 1990

- **Stocks won’t do well**:
  *“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”* - Ray Dalio ➔ Said in February 1992

# S&P 500 from 1990 to today



# Uncertainty is always around!

- 1990 to 2019 was *rough* for the world; there were multiple crises **every single year** (see next table, mostly from Morgan Housel, for *non*-exhaustive list)

| Year | Events | Year | Events | Year | Events | Year | Events |
|---|---|---|---|---|---|---|---|
| 1990 | Persian Gulf War; oil spike; US recession | 1997 | Asian financial crisis | 2004 | Tsunami hits South Asia; Madrid train bombings | 2011 | Japan earthquake; Middle East uprising |
| 1991 | USSR breaks up; real estate down turn | 1998 | Russia defaults on debt; LTCM hedge fund meltdown; Clinton impeachment; Iraq bombing | 2005 | Hurricane Katrina; London terrorist attacks | 2012 | Speculation of Greek exit from Euzorone; Hurricane Sandy |
| 1992 | Los Angeles riots; Hurricane Andrew | 1999 | Y2K panic; NATO bombing of Yugoslavia | 2006 | North Korea tests nuclear weapon; Mumbai train bombings; Israel-Lebanon conflict | 2013 | Cyprus bank bailouts; US government shuts down; Thai uprising |
| 1993 | World Trade Centre bombing | 2000 | Dot-com bubble pops; presidential election snafu; USS Cole bombed | 2007 | Iraq war surge; beginning of financial crisis | 2014 | Oil prices collapse |
| 1994 | Rwandan genocide; Mexican peso crisis; Northridge quake strikes Los Angeles; Orange County defaults | 2001 | 9/11 terrorist attacks; Afghanistan war; Enron bankrupt; Anthrax attacks | 2008 | Oil spikes; Wall Street bailouts; Madoff scandal | 2015 | Euro currency crash against Swiss Franc; Greece defaults on loan to ECB |
| 1995 | US government shuts down; Oklahoma City bombing; Kobe earthquake; Barings Bank collapse | 2002 | Post 9/11 fear; recession; WorldCom bankrupt; Bali bombings | 2009 | Global economy nears collapse | 2016 | Brexit; Italy banking system crisis |
| 1996 | US government shuts down; Olympic park bombing | 2003 | Iraq war; SARS panic | 2010 | European debt crisis; BP oil spill; flash crash | 2017 | Bank of England hikes interest rates for first time in 10 years |

# Uncertainty is always around!

- 1990 to 2019 was *rough* for the world; there were multiple crises **every single year** (see next table, mostly from Morgan Housel, for *non*-exhaustive list)

- **Key Takeaway No.1: Uncertainty is always around, but that does not mean we shouldn’t invest**

# Do market outlooks really work?

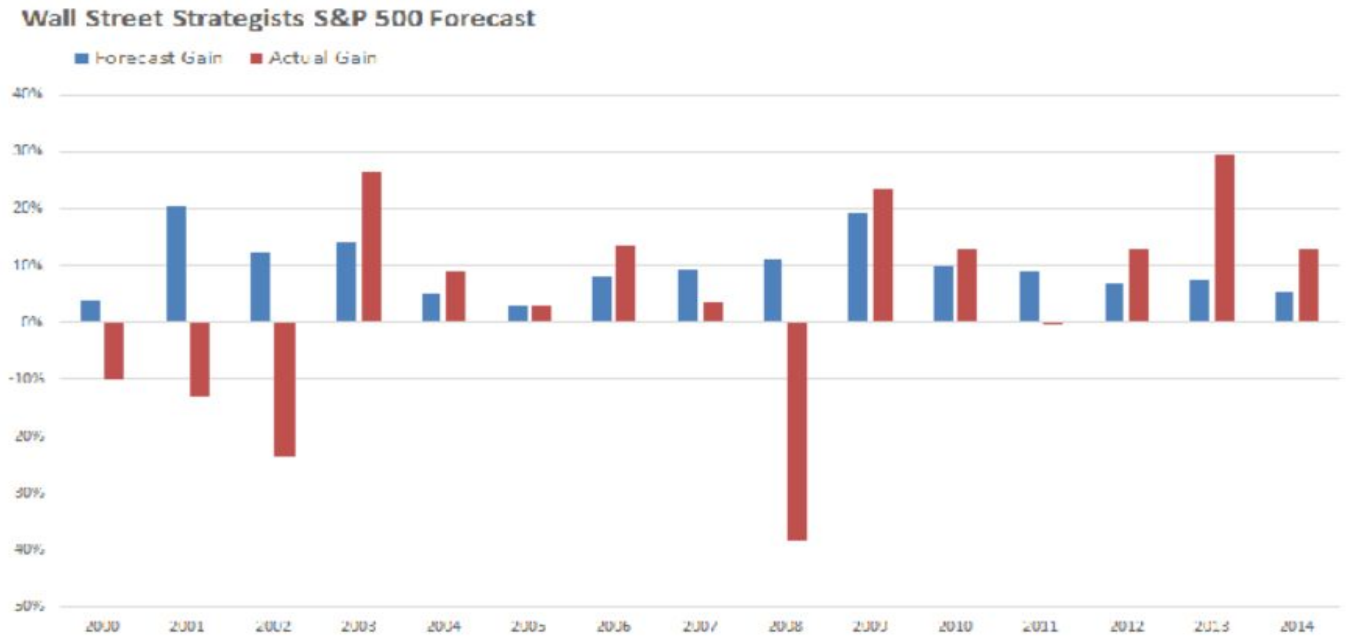
- Who will win a forecasting contest of guessing the return of the US stock market every year?

- **Blue team**: Market strategists from the most prestigious financial institutions in the US

- **Green team**: A simpleton forecaster who assumes the US stock market goes up by 9% every year

- Turns out…. **Green WINS!!** From 2000 to 2014, **Blue** team's forecasts were wrong by 14.7 percentage points per year; **Green** team's forecasts were wrong by 14.1 percentage points per year

# Do market outlooks really work?




SOURCE: BIRINYI ASSOCIATES, S&P CAPITAL IQ.

*[From Morgan Housel]() - Blue bars show strategists forecasts from 2000 to 2014; red bars show actual S&P 500 performance for each year*

# Market crash frequency (1928 - 2013)

| Percentage decline in S&P 500 | Historical frequency |
|---|---|
| 10% | Every 11 months |
| 20% | Every 24 months |
| 30% | Every decade |
| 50% | 2-3 times per century |

From Morgan Housel

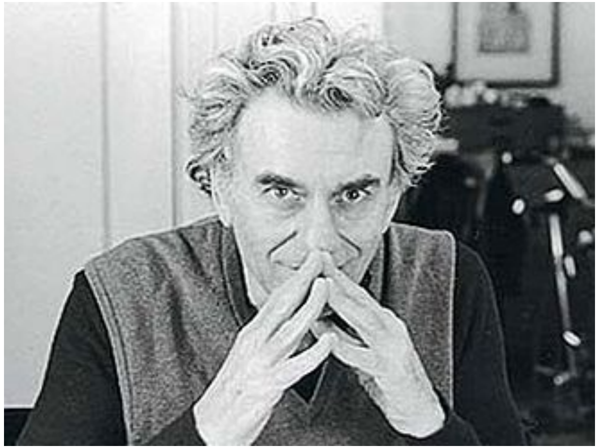
**Key Takeaway No.2: It is perfectly normal for us to experience market crashes multiple times throughout our entire investing career**

# Why do market crashes happen?

- Economist Hyman Minsky (1919 - 1996): largely ignored when he was alive, but gained popularity after the 2007-09 financial crisis

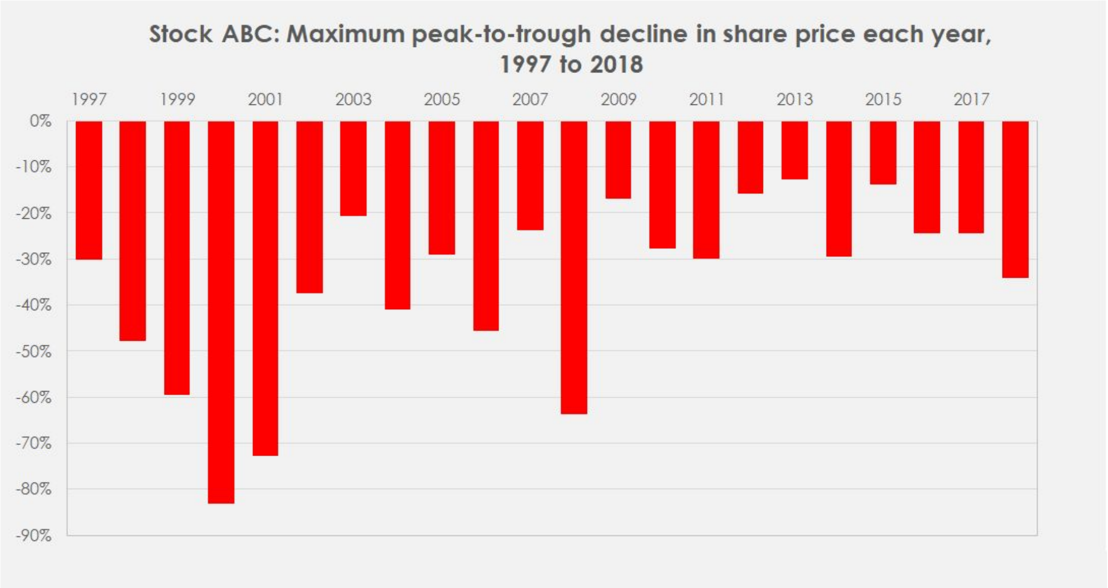
- Minsky theorised that stability is *destabilising*

- If stocks were guaranteed to rise 9% per year ➡ Investors pay up for stocks ➡ Stocks too expensive to return 9% per year, or market becomes fragile with debt (due to investors borrowing to invest) ➡ When bad news happen, stocks fall



# Which stock will you pick? ABC or DEF?

**Stock ABC**: Listed in 1997. From 1997 to 2018, *peak-to-trough decline* in share price for each year had ranged from 12.6% to 83.0%; so there has been a double-digit fall *every single year*



# Which stock will you pick? ABC or DEF?

**Stock DEF**: Also listed in 1997. From 1997 to 2018, stock price climbed from US$1.96 to US$1,501.97, for an astonishing gain of over 76,000%.

# Which stock will you pick? ABC or DEF?

- So which stock will you go for, given the information we just saw?

- Surprise! Stock ABC and Stock DEF **are the same stock: Amazon**

- **Key Takeaway No.3**: **Volatility in stocks is a feature, not a bug.** Even the best long-term winners in the stock also suffer from sharp short-term declines.

# Expect, DON'T predict

- **BIG** difference between *expecting* and *predicting*.

- An **expectation:** “If we invest for many years, we should count on things to get ugly a few times at least.” A **prediction**: “The US will have a recession in the third quarter of 2020.” (It’s *really* difficult to predict - many get it wrong)

- If we have expectations only, we won’t be surprised with downturns. Our portfolios can also handle a wide range of outcomes.

- If we predict, we think we know when something will happen. Our portfolios are likely to be able to thrive only in a narrow range of situations - if a different outcome happens, then our portfolios will be ruined.

# How to prepare

- Reasoning from 1st principles: What is the stock market? It is a place to buy and sell pieces of actual businesses

- So what makes the price of a share increase over the long run? ➜ If the underlying business grows!

- From 1965 to 2018, book value (assets less liabilities) of Warren Buffett's Berkshire Hathaway's grew by 18.7% per year while its share price increased by 20.5% per year. Input of 18.7% has led to output of 20.5%.

# My investment framework

Can be found at thegoodinvestors.sg (under “Investing Knowledge Base”). There are six criteria:

1. Revenues that are small in relation to a large and/or growing market, or revenues that are large in a fast-growing market.
2. A strong balance sheet with minimal or reasonable levels of debt.
3. Management with integrity, capability, and an innovative mindset.
4. Revenue streams that are recurring in nature, either through contracts or customer-behaviour.
5. A proven ability to grow.
6. A high likelihood of generating a strong and growing stream of free cash flow in the future.

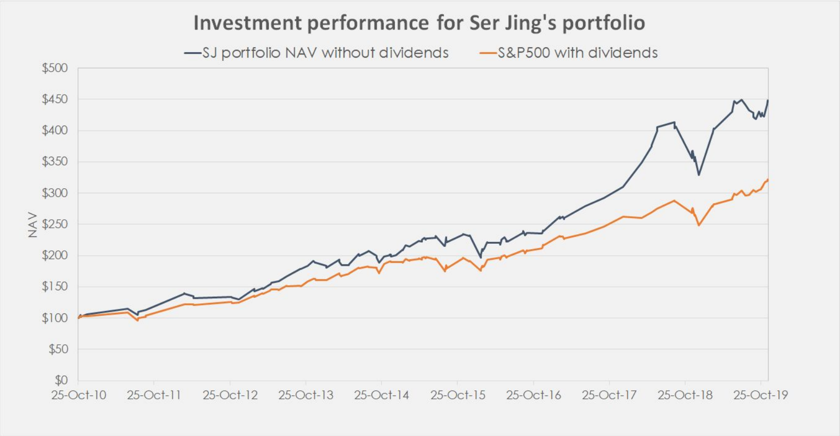
# My investment framework

- I want companies that can excel in all or most of the six criteria

- But companies that excel can still turn out to be poor investments ➔ **Key Takeaway No.4: It's important to diversify!**

# How the framework has worked

## Family's portfolio, Oct 2010 - Nov 2019 (unaudited)




## With the Motley Fool Singapore

- Flagship investment newsletter, *Stock Advisor Gold* (SAG), launched in May 2016
- Recommended 2 stocks per month (1 from Singapore, 1 from International markets)
- As of 31 October 2019, SAG has return of 30.6%, vs a gain of just 16.4% for global stocks

# Protecting my portfolio

- My investment framework is not meant to protect my portfolio from short-term declines in stock prices

- Protects my portfolio by finding companies with strong free cash flow, strong balance sheets, and high levels of recurring revenue - these traits enable a company to thrive or even flourish in tough times

# Case Study: PayPal

## Background

- I first bought PayPal shares for my family portfolio in June 2016 at US$38, again in November 2018 at US$83, and yet again in June 2019 at US$117.

- PayPal share price around US$106 today

- I’ve not sold any shares of PayPal

# Case Study: PayPal

## Business of PayPal

- PayPal runs a digital and mobile payment network. Brands include PayPal, Braintree, Venmo, and Xoom

- It handle transactions in over 200 markets, and allow its customers to receive money in 100 currencies, withdraw funds in 56 currencies, and hold PayPal account balances in 25 currencies

- First listed in 2002, then privatised by eBAY a few months later; spun-off from eBAY in mid-2015 as a new IPO

# Case Study: PayPal

**1. Revenues that are small in relation to a large or growing marketing or revenues that are large in a fast growing market**

- Digital and mobile payments market worth US$110 *trillion*
- Around 80% of transactions in the world still settled with cash
- In 12 months ended 30 Sep 2019, PayPal processed US$676 billion (or US$0.676 trillion) in transactions and earned US$17 billion in revenue

# Case Study: PayPal

**2. A strong balance sheet with minimal or a reasonable amount of debt**

- US$5.0 billion in debt on balance sheet against US$6.9 billion in cash, as of 30 September 2019
- Making US$4 billion acquisition of discount-discovery service Honey soon
- But PayPal has good track record in generating free cash flow

# Case Study: PayPal

**3. A management team with integrity, capability, and an innovative mindset**

- In 2018, most of the compensation of PayPal's key leaders came from:
    - *Stock awards that vest over three-years*
    - *Restricted stock awards based on growth in revenue and free cash flow over a three-year period*
    - *Stock awards that depend on the performance of PayPal's share price over a five-year period (specific to CEO)*

# Case Study: PayPal

## 3. A management team with integrity, capability, and an innovative mindset

- PayPal's network has grown impressively since spin-off from eBAY:

| Time period | Transactions | Growth in transactions from a year ago | Payments volume | Growth in payments volume from a year ago | Active accounts | Growth in active accounts |
|---|---|---|---|---|---|---|
| Year 2014 | 4 billion | 22% | US$235 billion | 26% | 162 million | 13% |
| Year 2015 | 4.9 billion | 24% | US$282 billion | 20% | 179 million | 11% |
| Year 2016 | 6.1 billion | 24% | US$354 billion | 26% | 197 million | 10% |
| Year 2017 | 7.6 billion | 24% | US$451 billion | 27% | 227 million | 15% |
| Year 2018 | 9.9 billion | 27% | US$578 billion | 27% | 267 million | 17% |
| First nine months of 2019 | 8.9 billion | 27% | US$513 billion | 24% | 295 million | 16% |

# Case Study: PayPal

## 3. A management team with integrity, capability, and an innovative mindset

- PayPal has been striking up strategic partnerships in many areas since becoming an independent company


# Case Study: PayPal

## 4. Revenue streams that are recurring in nature, either through contracts or customer-behaviour

- PayPal’s revenue comes primarily from taking a small cut of its platform’s payment volume
- Processed 8.9 billion transactions in the first nine months of 2019 from 295 million active accounts
- No single customer accounted for more than 10% of PayPal’s revenues in 2016, 2017, and 2018.

# Case Study: PayPal

## 5. Proven ability to grow

| Year | Revenue (US$, billion) | Net profit (US$, million) | Diluted earnings per share (US$) | Operating cash flow (US$, million) | Free cash flow (US$, million) | Net cash (US$, million) |
|---|---|---|---|---|---|---|
| 2012 | 5.7 | 878 | - | 1,565 | 1,054 | - |
| 2013 | 6.7 | 955 | 0.78 | 1,993 | 1,602 | 501 |
| 2014 | 8 | 419 | 0.34 | 2,22- | 1,728 | 1,108 |
| 2015 | 9.2 | 1,228 | 1 | 2,546 | 1,824 | 1,393 |
| 2016 | 10.8 | 1,401 | 1.15 | 3,158 | 2,489 | 1,509 |
| 2017 | 13.1 | 1,795 | 1.47 | 2,531 | 1,864 | 1,883 |
| 2018 | 15.5 | 2,057 | 1.71 | 5,483 | 4,660 | 5,577 |

# Case Study: PayPal

## 5. Proven ability to grow

- PayPal's business exhibits classic network effect: Competitive position strengthens when its network increases in size

- PayPal's digital wallet Venmo is highly popular among US millennials, with over 40 million accounts

- Annual run rate of Venmo's revenue has exceeded US$400 million, double the US$200 million seen in 2018's fourth quarter.

# Case Study: PayPal

**6. A high likelihood of generating a strong and growing stream of free cash flow in the future**

- PayPal has excelled in producing free cash flow from its business for a long time, and has huge growth opportunities ahead.

- There's no reason to believe these will change any time soon.

# Case Study: PayPal

## Valuation

- I like to keep things simple. PayPal's strong history of producing positive and growing free cash flow makes the price-to-free cash flow (P/FCF) ratio useful

- Right now P/FCF ratio - adjusted for one-offs - is 34

- For context, PayPal's P/FCF ratio was only around 28 in the early days of its 2015 listing

- But I'm happy to pay up for quality

# Case Study: PayPal

## Risks

- Payments is highly competitive

- PayPal has deal with eBay to help eBay process payments; deal expiring in July 2020 and eBay is not renewing

- Regulations can limit PayPal’s fees

- Recessions can harm PayPal’s business

- US$4 billion purchase of Honey is PayPal’s largest acquisition thus far; steep price (more than 20x forward earnings)

- Succession risk

# Reminder!

- **Key Takeaway No.1: Uncertainty is always around, but that does not mean we shouldn't invest**

- **Key Takeaway No.2: It is perfectly normal for us to experience market crashes multiple times throughout our entire investing career**

- **Key Takeaway No.3: Volatility in stocks is a feature, not a bug**

- **Key Takeaway No.4: It's important to diversify!**

# Thank you!
# The end

**Blog**: *The Good Investors*, thegoodinvestors.sg

**Contact:** thegoodinvestors@gmail.com