ATLAS ASSET MANAGEMENT PTE. LTD.

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Ideas for the next (mini)-crash

1. Quiet August

It's hard to stay awake in August with markets at such a lull — September and October however are seasonally volatile months so the peace could be shattered in a heartbeat. We could thus never rule out a (mini)-crash around the corner. In the short run the market gets it wrong as often as it gets right, and reflects nothing more than the hopes and fears of many irrational people and increasingly computerized momentum short-term trading.

My fundamental view is that US economy is chugging along fine — the household sector remains resilient, while income and consumption continue to enjoy solid growth. The other major economies (EU, Japan, China) are also showing signs of stability. According to BAML fund manager's survey a lot of investors are still cashed up. Therefore I will view a mini-crash as an opportunity to deploy cash. Here are some ideas on what we can do during the next market crash.

1. Idea # 1: When the market thinks a business will become obsolete—and it doesn't

Ok, that's quite a mouthful. I believe you have heard about how disruptive technology displaces markets and causes business to go obsolete (think digital music replacing cassette tapes). Disruptive technology is a great idea which I will expound on in a moment. In the meantime I want to highlight this contrarian strategy of betting on so-called obsolete businesses, because the market can get it wrong as well. Such businesses may often trade at depressed valuations but when the market realizes that the business will not go away the share price will appreciate meaningfully.

To be sure, if something looks like a dying business, it probably is. That being said there should still be gems out there which are not appreciated by the market.

Let us consider Diebold as a case study. Diebold was founded in 1859 as a manufacturer of safes and vaults. It is now best known as an ATM maker, and is the industry leader by market share (after purchasing German rival Wincor Nixdorf). At first blush, the cash machine business seems like a declining market with tight margins, in intense competition with cashless alternatives such as Paypal and new entrants such as Google, Apple, Facebook and Samsung.

Instead of giving up on the ATM, Diebold is doubling down on it, making 'smart ATMs' with features such as allowing smartphone links on its machines, and recognition tools with biometrics, iris scans, and thumb prints. By incorporating new technology into ATMs, Diebold also thinks that the replacement period for them will shorten from the current 7-to-10 years down to between 24 and 36 months, thus boosting profit margins.

Of course, all this is premised on the fact that cash will still be widely used in the future, and that the ATM will not become obsolete. Remember the street directory? It was a quaint thick book that is quintessential to ...

1. (continued)

...every car driver, tucked away snugly in the seat pockets, safe and secure in the fact that it won't be discarded (until a newer edition comes out, that is). And why would it feel insecure—after all it has been in use for at least a century. Ah, I still recall with fond nostalgia those days of flipping the pages furiously, often aided by several bookmarks because if you move east you will go from page 10 to 11, but if you move south you have to jump to page 117, and so on. These days, no one even bothers to install a GPS navigator in their car, as they simply let Siri lead the way.

So the question is, will cash go the way of the street directory? I am inclined to think the 'death of cash' is overrated, just as there was this notion that computers would displace paper in the 1970s. Even in this day and age we still consume vast amounts of paper.

Besides, there are many industries are tied to the value chain of ATMs for them to go away, from its designers and manufacturers to the armored car companies that move around cash. Many countries and regions still need ATMs , especially in markets such as China, India and Latin America.

2. Idea #2: Boring Businesses

This is where the market thinks that the business is boring and that there is limited upside. However, boring can be very good, especially in uncertain times.

Warren Buffet once said, "our approach is very much profiting from lack of change rather than from change. With Wrigley chewing gum, it's lack of change that appeals to me. I don't think it is going to be hurt by the Internet. That's the kind of business I like."

Take Hershey for example, the largest chocolate maker in North America. They have been making chocolate for a hundred years. Will a rate hike or terror attack or internet stop us from eating chocolates? Nay, for I am convinced that neither angels nor principalities nor powers, nor any other created things, shall be able to separate us from the love of chocolate.

We should also be on the lookout for criticism against the firm, for that can help to bring the share price lower for better entry levels. For example, some analysts have criticized the firm, saying it needs 'aggressive efforts to fuel long term growth'. Analysts sometimes love to say stuff like these even though the underlying business is fantastic, and as if management is so stupid to not think and plan for growth.

The share price hovered around $90 for much of the year before Mondelez offered to buy out the firm for a final price of $115. As I write, the deal has fallen through but it does give you a sense of where industry experts value the stock.

However, this has already been the year of the STUDs: Stables, Telecoms, Utilities and Dividends (coined by Todd James). These sectors have been performing very well so far this year. Buffet said 'it's far better to buy a wonderful company at a fair price than a fair company at a wonderful price,' hence the idea is to wait to get in at better levels or look at specific companies which have sold off.

3. Idea #3: Disruptive Technologies

Disruptive—definitely one of the buzzwords of our times now. We can look for opportunities in disruptive technologies or innovations, which is broadly defined as an innovation that creates a new market and value network and eventually disrupts an existing market and value network, displacing established market leaders.

Disruptive Technology Explained

To sum it up: Innovation improves a product by either ***improving performance or by improving affordability***. Broadly there are two types of disruptions, 'low-end disruption' and 'high-end disruption'. We can think of low-end disruptors as those who enter the market with a low-performing, low-price product and then work to improve performance, while high-end disruptors enter the market with a high-performing, high-price product and then work to improve price. The disrupting entrant eventually takes over the entire market with a high-performing, low-price product.

In low-end disruption (which seems to be the more common type of disruption), the disruptor is focused initially on serving the low end customer, who is happy with a good enough product. This type of customer is not willing to pay a premium for enhancements in product functionality. Meanwhile, the incumbent tends to focus on its most profitable customers to derive the best margins and often have products with many functionalities that are hardly used. Once the disruptor has gained a foothold in the low end customer segment, it will move on to other segments where the customer is willing to pay a little more for higher quality, etc. The incumbent will not do much to retain its share in a not-so-profitable segment, and will move up-market and focus on its more attractive customers. Finally, the disruptive technology meets the demands of the most profitable segment and drives the established company out of the market.

An example of a low-end disruption was in the 1960s, whereby General Motors (GM) held 50% share of the US automobile market and 80% of the industry's profits. GM's integrated value chain allowed it to dominate the industry in an era where products were still not "good enough" (with respect to performance and reliability). But as automobile performance improved, "low-end" disruptors like Toyota attacked it from below and profits evaporated. Toyota did not succeed by immediately attacking the premium segment of the market. It started with the low-end Corona and "then moved up-market by introducing sequentially its Tercel, Corolla, Camry, Avalon and 4-Runner models, and ultimately its Lexus". Honda and Nissan followed similar approaches to disrupt integrated incumbents like GM, Ford and Chrysler.

Similarly, high-end disruption is where a disruptor encroaches on an incumbent's product line from the high-end. A high-profile example of a high-end disruption is Apple's iPhone. Apple debuted the product in 2007, targeting the same customers coveted by incumbents, pricing it at the high end and was regarded as high performing. It changed the landscape of the phone, camera and laptop industries. The traditional cellular phones (think Nokia) were phased out, and consumers stopped carrying a camera and a phone together, relying on the camera phone instead. By building a network connecting application developers with phone users, Apple changed the game, creating a new market for internet access and eventually challenged laptops as mainstream users' device of choice for going online.

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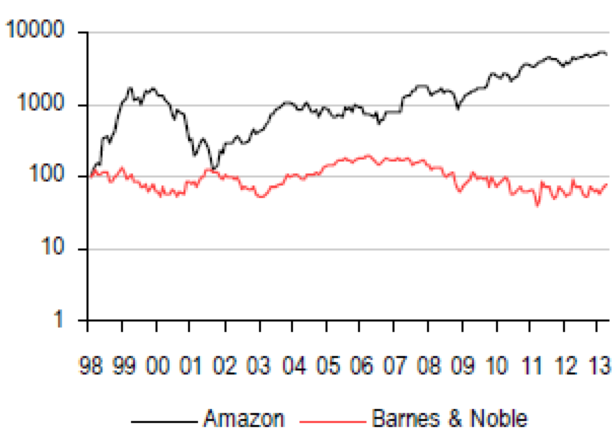
Losers are easier to spot than winners

The pitfalls of investing in disruptive technology is that even if we successfully spot the disruptive technology, it is still far easier to identify losers then winners. This is because developers of a disruptive technology will tend to be small companies and there will be many of them, with competing versions of the new technology. There will be few survivors and many failures.

Take for example the internet. By the late nineties, it is evident that the internet is going to be the future. We can foresee the demise of business models disrupted by this innovation (booksellers, travel agents, newspapers, music and video retailers), but it is much harder to spot Amazon, Google and Apple as the biggest winners.

Picking the winners would certainly be highly remunerative. Amazon's stock price has risen 50 times since 1998, while Barnes and Noble is 20% below where it was 15 years ago.

3. Amazon stock price vs Barnes & Noble stock price (log scale)



Source: HSBC, Bloomberg

Chart 1: Amazon stock price versus Barnes & Noble stock price

Another challenge is that such stocks are often priced to perfection, such that just one quarter of missed earnings will send the stock crashing. Oftentimes the firm might not even be earning a single cent. Facebook for example had a price earnings ratio of greater than 80 in 2015. Its earnings had grown as predicted or exceeded expectations, thus it is doing very well so far. There are however countless examples of tech stocks faring badly.

Since we are talking about disruptors, Alphabet, the parent company of Google deserves a mention. While this greater-than-10x multi-bagger is seen more as an incumbent than disruptor now, its leadership in search advertising, monetization of Youtube, and the growth potential of google maps, cloud applications, google car and artificial intelligence, leads me to believe in the long term potential of the firm.

Finally, let's talk about Tesla, whose story has been going on for awhile now and is seen as a high-end disruptor, jumping into the market at the very top by initially selling electric cars at a premium price. The fact that many car makers are also pushing into electric cars suggest that this is a profitable market. I will not be surprised if the developed world becomes dominated by driverless electric cars in a 3-5 years' time with Tesla being the market leader. That being said, for reasons explained above this doesn't mean necessarily mean the stock is a buy at this point in time.

Sources:
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- Wikipedia
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- Harvard Business Review: What Is Disruptive Innovation? Dec 15

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