Transcript of Interview with Hayden Capital's Fred Liu

Interview by Aaron Edelheit

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*Lightly Edited for Readability

Aaron: I just want to say congratulations. I was looking at how long you've been managing money and it's not like you're new to this and it's not like you're an overnight success, so I just want to say congratulations. Of course, I'm envious!

If I go back in time, though, and look at your fund's performance, at the end of 2018, I don't see anything special or extraordinary that kind of shows me what's coming. And then in 2019, obviously, you had a wonderful year up forty one percent. And then the first three quarters of this year you're up one hundred and sixty four percent. Was there any change to your process, your research, your thought process, the way you ran your fund, or was this just the culmination of years of work? I would really love to understand.

Fred: I'd say it's more of the latter, the culmination, because honestly, we haven't changed that much. The investment philosophy is the exact same as it was since day one. It just may be the circle of competence, I think has narrowed over time, actually. So, if you look in the early days, yeah, we had a lot more traditional industries in there. If you look back at our portfolio, there were companies and, you know, for instance, subprime auto loans (companies) There were other similar positions like that. And I think over time I just realized; I wasn't using my own network of people I knew. So, a lot of our process relies upon like finding information that, again, doesn't live inside of public filings. And so, you need to have a good network for that. Right? A good roster of people that you can call up to share notes and kind of pick their brains on and get information from. And it's just my network of people happens to live within the consumer tech space inside of Asia and in the US. And I think, you know, it wasn't necessarily like one day I woke up and said, oh, let's just pivot. It was more a gradual, slow process of moving in that direction. If you look at our portfolio today, the vast majority is probably in the e-commerce space. Right. So that's really the bull's eye of competence. And then as these companies expand out, as they expand into new divisions, you know, our circle of confidence because we need to stay on top of this, will also expand naturally as well.

So, I'm hoping, I think we're at a good spot right now where really the fund is focused on consumer tech in US and in Asia and hopefully over time that will slowly start expanding concentrically outward again. But, yeah, I just say that, you know, the names that provided our returns this year, you know, for instance, Sea Limited (NYSE: SE) and Carvana (NASDAQ: CVNA), we bought back in late 2018. Right. That helped propel some of the 2019 return; Sea helped a bit with this year's returns also. But really the process is the exact same. I just say Covid, you know, we can talk about this a little bit later, but for our companies, a lot of them were hadn't reached critical mass yet. There's usually a point in product adoption where you get an inflection point, right. Like first it's the early adopters who are using your product or growing at a relatively decent clip, but it hasn't caught on with the masses yet. And I think an event like Covid for our companies got them to that inflection point quicker. The sort of step function change where you saw demand go up, say, 100 percent, 400 percent.

But what that did was basically make their businesses sustainable. And then going forward, there's an effect in these businesses, too, because a lot of them are winner take all. And so when your relative share versus next largest competitor actually widens, that makes you a much more durable company and makes you more self-sustainable. You have more profits. Go reinvest in the business and you just pull away from the pack after that point.

Aaron: Yeah, it lowers the risk.

Fred: Absolutely. You get your multiples go up and to the right. Because when we invest, it's probably two years before they reach that point. And we have a thesis for what's going to get them towards that inflection point. And so, yeah, the multiples that we're usually paying at that point in time are lower because there's a lot of uncertainty in the market. There's the question around the market, how are they going to send off all the competitors? Why is this company going to be a dominant winner as opposed to competitors? But we have a thesis around like why their execution is better and why they're going to be able to run quicker towards it. And so, when they do hit that point, that's when the whole market kind of wakes up and says, holy crap, this is going to be the company that takes 80 percent of profits inside of this industry. And they do get a multiple expansion at that point.

Aaron: I want to go back to something you said that is really fascinating to me on how you had this business network or this network of people that you built over time, in the consumer tech space, and how when you started out, you're owning subprime loan kind of companies, and then

you start leaning into your network. I'm curious of how you started thinking more about your network and growing that network beyond just, let's say, traditional value. And suddenly when you started to realize, like, hey, I have this network and then growing it and then putting time into understanding your network. And then deciding to really activate that network, I'm really fascinated by that, just how that happened.

Fred: I mean, when I started Hayden Capital, what, like five, six years ago, I had no network at all. I basically knew no one in the industry. My prior experience was in finance, but it didn't necessarily overlap with the network that I have now. I would say to think of us as a startup as well, where we were trying to find product market fit. We were trying to look for things that actually work. And what happened was, our letters were getting sent around a lot. I would proactively put out calls for, like, hey, I'm traveling to X, Y, Z city. Let's meet for coffee. Let's, you know, whoever is interested, whatever, investors, entrepreneurs. Want to meet me for coffee?

Let's set up a time to meet and then over time the network just kind of built upon itself and I realized, hey, I actually have a pretty good network of people to talk to that I can share ideas with regularly, maybe that's something that we should lean into. So, I would say that wasn't necessarily planned. Again, it wasn't like some grand master plan, but it's as your business evolves and it's similar with any other company out there, right? You see what sticks. You see what works. You're going to try 10 things. Maybe two of them work. And you find what helps your business perform and execute at a high level. And then you lean into that and you continue doing that. And so that's just kind of what happened with Hayden.

Aaron: I love that idea, that someone starting out in money management considers it just like a startup and trying to find product market fit and then seeing the results like you were a venture backed startup. You can see it in the numbers, how you nailed your product market fit. So, I love that idea. That is really, really fascinating. I actually think it's really helpful to other money managers who are starting out or on a smaller level to think in those terms. And it's fascinating just hearing you talk through and think about how you're thinking about your firm and growing and your philosophy. So, thank you for sharing. Really great.

Fred: No, I mean, look, we really were a startup, right? We started with a couple of million bucks to begin with, so it wasn't much at all. And so, yeah, I mean, even as businesses evolve, I think the best businesses say they have to continue to learn and iterate even when you're running, you

know, several billion or 10 billion or 20 billion dollars, you know, how investors die and how investment firms die is that they don't iterate with the times. They are stuck in a set way of investing in their own process because that's what their own LPs are underwriting. And they're scared to change that process over time as the market evolves. I think that's something that most people kind of need to understand because, I mean, heck, look at Amazon and their day one mentality. They're continually iterating, evolving their business model. I think investment firms need to do the same.

Aaron: That's great, great advice. When I read through your letters, I was really struck that sixty four percent or so of your portfolio is located outside the US. And I wanted to ask why you think that is and what opportunities you see outside the US that others are missing and why those opportunities exist.

Fred: I'll just say, number one, it's a function of my own network and circle of competence and my own interests as we focus, as we've narrowed that circle of competence in consumer tech right now. Obviously, that's going to change in 10 years, 20 years. But basically, the thing is that, you know, we're looking for the best companies and the best entrepreneurs, right. When you're investing in a business for 10 years, the only things that don't really change are the management teams and the cultures that they've built. So, the question is, where do you find the best management teams and where do you find like the most innovative cultures? In my opinion, that tends to happen in the US, and it happens in Asia today. There's a lot of cross pollination in terms of business model businesses learning from each other. The example of like, say, PayPal and Venmo, learning from Alibaba and WeChat or heck, Snapchat, learning from WeChat as well. You're seeing a lot of cross pollination between the two geographies.

So that's kind of where the focus is on. And it just so happens to be that Asian markets, especially in the tech field and especially in, say, outside of China, like Southeast Asia, is far less competitive. And you can also see where capital is abundant. Also, if you look at, for instance, I mean, there's an extreme example, but if you put money in a Vietnamese bank, it's six percent interest rates. Right? In Indonesia, it's three and a half, four percent interest rates. So, you can just see where capital is actually plentiful and where capital is scarce. And you can get the same data points by just talking to startups in these regions and learning how hard it is for them to raise capital. And that's applicable not only for those companies trying to raise like two million dollars or five hundred thousand dollars all the way up to 20 million, 50 million dollars. There's

still a funding gap up there. And because there's this dynamic, you're going to get, you know, theoretically higher returns in these markets for that reason.

Aaron: And how deep of an opportunity do you think? When I think about Southeast Asia, I love the idea of kind of learning what companies are cross pollinating successful kind of models. But how deep is that opportunity to find those investments? Or do you see eventually that you'll be invested, for example, in Vietnam, in the Vietnamese leader, and that it's going to be years of following these opportunities? How do you think about that?

Fred: So, I think China has a very robust market at the moment. And Hong Kong as a proxy for that, at least the companies listed in Hong Kong, Japan is starting to develop their own tech ecosystem, although historically there hasn't been much of a venture community in Japan around tech. So that's just at a more nascent stage, I would say Southeast Asia. I think you have iteration number one of these companies. Maybe what needs to happen? It's like an ecosystem. Usually what happens is you need role models, basically. For instance, when Alibaba IPO'd, if you look at the startup statistics in China, there were a lot more startups started in the year following this IPO because Alibaba provided a role model that, hey, you can actually become rich, you can actually become like a world class leading company in China. And so, it provided the motivation for a lot of entrepreneurs to start off on themselves. And the same thing is starting to happen in Southeast Asia. You have the first iteration, you have the role models which are like, Sea (Limited), Grab, Gojek, what have you. And these were all created by basically returnees. Those who were educated abroad, had worked at Western companies and brought those talents back into the region. And it's happening is, you know, Sea Limited is like 80 billion plus market cap at the moment. You know, Grab and Gojek are not far behind. And they've created their own ecosystem of millionaires by this point. And Sea has created a couple of billionaires as well.

What happens is these people will usually leave these companies. They'll go start their own companies. They may start like angel funds or seed funds or series type of funds, and they're going to invest back into the ecosystem, back into their own countries, back into the tech ecosystem that's within their network. And then you plant the seeds again and then these companies will then grow up and then it's going to provide a more diverse ecosystem. So, I think it's a slow process, right? I mean, right now, if you look at the number of unicorns in Southeast Asia, it's basically I mean, really, it's like 10, 10 in Southeast Asia. It's not a very large market. But eventually these companies will become the role models for other entrepreneurs to follow in their footsteps. There's going to be more venture investment as well, because, you know, a lot of

venture capital firms that invest in Southeast Asia, they're investing out of their, say, Indian funds or it's Chinese that are using their China funds to invest in Southeast Asia. So, it's only starting to become Southeast Asia. It's becoming like a dedicated market. It's only been happening in the last like a year and a half or so. So, yeah, I think it's going to take some time to build out a breadth and diverse ecosystem, but it's going to happen over the next five to 10 years.

Aaron: And you think those opportunities will exist both in the private and public markets so that you'll be able to purchase and will be able to participate?

Fred: Oh, yeah, absolutely. Yeah. Eventually these companies you know, there's a lot of really high-quality companies that are probably, you know, sub hundred-million-dollar valuation at the moment. But they're going to IPO at some point in the next five years. They're going to grow, they're going to become successful and they're going to IPO and being early to the market, understanding the market, building your network there, hopefully will have an advantage as well when the time is ready.

Aaron: Makes a ton of sense. And obviously, if you're focused on these markets then you just don't have the competition. You don't have the other money managers looking at it. And it's more just a wide open or there's just a delay.

Fred: Yeah, I mean, heck, not even public investors like I think venture investors don't even have a dedicated Southeast Asian fund. And so, if you look at venture funding in Southeast Asia, funding this year is on track for 12 billion dollars. Last year, it was 12 billion dollars. You think about like a company like Sea Ltd., they're going to generate like a billion and a half just off their gaming business alone. And profits in addition to they did a couple of equity raises earlier this year. They basically take up like 30 to 40 percent of that entire venture funding market. Think about if you think about capital as an advantage, that's a real advantage. And, yeah, I mean, 12 billion dollars isn't a lot in the grand scheme of things, given how much opportunity is in front of this region. And yeah, I believe like US venture funds just raised somewhere 90 billion plus, you know, year to date alone, and that's in the U.S. So that kind of shows you that the gap in funding.

Aaron: Well, if you think about this gap, have you ever thought of expanding beyond just public equities management and based on your success, raising a small venture fund to kind of run the gamut, or do you see yourself just kind of sticking to public equities?

Fred: That's something I've been thinking about. I think my skill set is identifying good companies and, you know, basically making that call before they hit that critical mass level a couple of years beforehand. But I will say the private markets are different because even if you identify a good company, it doesn't mean you're going to win the deal. And it's a whole different process. And so, I think if we were to eventually do that, I would need to find someone with the right, with that skillset.

Aaron: I am now seeing more investors who are really bright and identify kind of an opportunity kind of they're doing a whole bunch of things. They're ranging the gamut when they see an opportunity to be all along the journey of a company. So, it just struck me that maybe you're in a position to kind of bridge the gap and you could find someone maybe more local. It's very clear you're on to something and it seems like an opportunity.

Fred: I would say that if we do it, we need to be conscious, though, because I think Hayden as a public fund hasn't necessarily proved itself yet.

I think it takes at least 10 years to prove out like an investment strategy like this. And at the same time, you know, on the private side, we would probably have to start small because it's a new business. You weren't sure if it works. You don't know if there's going to be attraction. You don't know what your skill set is. So, we're going to start small if we do it and then scale up over time.

Aaron: In your most recent letter, you make this point that discounted cash flows are great for companies that are optimizing, but not great for knowledge-based companies. And, you know, as a value investor, you know, one of our kind of tool sets is to learn from studying Buffett or any of the traditionally great value investors was like, hey, take a look at the cash flows that matter. And you have to, like, estimate and do this, just, you know, build this model. I really would love for you to expand on this point. And if you could use a specific example to kind of explain how you're thinking about how you analyze these knowledge-based companies; it would be enlightening for me.

Fred: Yeah, number one, it's a case-by-case basis. So, each company is different. But I will also say, you know, and I mean, one of the core tenets of value investing is the idea of a margin of safety. And that you don't want to basically pay for growth or future growth because you're unsure if that will happen. It's the similar way that I think about these companies as well, because as long as you are confident that this business is dominant or is going to be dominant and they

already have a very viable and sustainable business, you don't try to underwrite the future growth necessarily.

Good analytical starting point, especially in winner take most markets

We basically invert that DCF and say, what is this business worth today as it is, as long as it just maintains its market share and grows along with the industry and can kind of defend its position today, what is that worth? And then we know that there are these options on the horizon, say one, two or three options on the horizon. But we don't know the timing of that or necessarily the exact magnitude of it. Like how large the option will be if it works. But we have a rough idea of it. And so basically, we want to buy these companies without paying for these options at all. And you get moments like that when it's an earlier stage company where the market is skeptical whether this business will be self-sustainable or whether they will reach that critical mass. You usually get a lower valuation, a lower multiple that doesn't price in some of these options at the same time.

Or you can get a large market draw down like earlier this year, which allowed us to buy AfterPay (Australia: APT) when we were basically only paying for the Australian business at that point. And they had a very large call option on the US. And the US market is 10 times the size of Australia. So, it's a large addressable market. You know that the product works in one geography. And so, what you need to underwrite is that is consumer behavior in the US similar to that in Australia. What made it work in Australia? What was it that consumers found attractive about the product? And is it going to apply to the US? And then that's what really what you're underwriting. And we're hoping we don't pay anything for that call option. And even if we're wrong, if we cut off one leg of their business, which is the US business, retrench and just focus on Australia. And, you know, that's going to be a pretty good investment still because they're still continuing to grow 50 percent, even though, you know, there have about 20 percent of the Australian addressable population as customers. So that's one example. Another example is like Sea Ltd launching ShopeePay. They already had a gaming business, then had an e-commerce business towards the end of last year. Some key executives were basically talking up ShopeePay through a couple of channels. And you can tell that it was going to be a big push for them. We also heard three different sources that they were aggressively hiring for their fintech division and shopping basically like they couldn't hire people quick enough, which also signaled that this year was going to be a big year for that division or that was the way that management was thinking prior.

If you just looked at the financials, it looked like ShopeePay or the fintech division wasn't growing at all, but we knew that it was coming on the horizon because of how aggressive they were hiring, how much focus they were putting on it. So, we knew that was an option. And we have an idea of if the wallet is successful for them, how large of an opportunity that can be. And also, you need to think about the value of that option, too, in terms of synergies with the existing business lines. So, for instance, in shopping about 20 to 30 percent of transactions are never completed because how it operates in South-East Asia. Let's look historically at least there was a lot of cash on delivery or you have to make a bank transfer. And so, if you buy a product and you go all the way to check out, then you have maybe about five hours to then go to your local convenience store and go initiate a bank transfer to go and complete that transaction. But the problem is a lot of people just get distracted, never go to the store to actually complete that transaction so it gets cancelled. Well, if you have an easier payment method such as that, your wallet, that kind of lowers the percentage of transactions that are never completed.

Even if the wallet itself never becomes the number one leader, it still benefits from the shopping business itself in terms of narrowing the gap between that GNP and close to empty.

So, I think that, yeah, those are just two examples, but these are very large options where we didn't have to exactly know the timing or the magnitude, but we knew that they were on the horizon. And if they were successful, they would just basically increase the IRR of an already attractive investment.

Aaron: So, if I understand correctly what you're doing with these kind of knowledge companies, you're finding companies where you're saying, OK, I can value it just on the opportunity that it has now. And it's kind of trajectory with what is known now. However, what you can't value with the traditional DCF is that there are these hidden options that the company is actively working on that are not being priced correctly. Now, you're not saying that they are guaranteed to work, but that there should be some kind of value and that when if you're getting feedback from your network and your research at some of these are taking off, that the market wasn't recognizing or valuing these rather enormous opportunities, whether it's AfterPay going to a 10 times larger market or with Sea with their e-wallet initiative, that you were seeing signs like these huge potential and that these very valuable options were not were not being properly valued, is that the right way to think about it?

Fred: Yes, it's two things. It's either it's not being valued correctly or it's you know; people don't even know that the options exist in the first place.

Aaron: Yeah, that's right. And so, you can identify this large kind of total addressable market or this large initiative that could drive substantial value, and no one's even paying attention that this company is even working on that.

Fred: Yeah. Yes, exactly.

Aaron: It probably helps as well that you're focused on a region that no one's looking at while everyone's looking Apple (NASDAQ: AAPL) and there's tens of thousands of people looking at everything they announce. How many people are looking at Sea Limited?

Fred: Well, nowadays, a lot more than one. Oh, yeah. Yeah.

And I'd also say, I mean, the original option for Sea was going from a gaming business into e-commerce. Everyone knew about that option. They knew that they were going to e-commerce, but they described the negative value to that option because they thought that it was a bad use of capital. And so that's another I'd say that's the third case that you can have. Everyone knows about the option but are negative on it. And so, they're giving it actually a lower valuation. But your differentiator is that you think the option will actually become valuable and will work over time.

Aaron: That's really a similar kind of thesis on Nintendo (Japan: 7974, US: NTDOY) that everyone is kind of giving negative value to their strategy on hardware and software. But that's a separate comment. So, can you give me your AfterPay pitch as it stands today? Not in the past. I'm looking at AfterPay today and I know it's had an enormous run. What is the pitch for an investor today? And why, AfterPay and not Affirm and when I looked at it, I had trouble trying to discern just from not knowing much what the long-term competitive advantage is to either company or the industry in general. Yeah, so there's a lot in there.

Fred: Anyone who is interested can obviously read our actual slide deck and presentation on our website. But really the opportunity for the entire buy now pay later industry is capturing the trend of the younger generation, such as Gen Z and younger millennials really turning away from credit cards. They are becoming disillusioned with taking on debt. There's really a big move to

becoming financially independent, not having any debt. And the problem is they saw their parents throughout the financial crisis. Heck, even this recent Covid crisis face financial troubles. And at the same time, there's a large amount of student loans that a lot of them are holding. So, they aren't they don't have the same, they aren't as receptive to taking on that as maybe prior generations.

So that's the big trend, the second one is really within buy now, pay later. I mean, it's like you mentioned, it's an easy product itself to create. If you think about the value of, say, Visa versus MasterCard. What's the real difference between the two? The product itself and how it functions is the same. The difference is where is it accepted? Visa has the slogan, we are accepted everywhere, whatever. And it's the same case with most payment companies. Your moat is really around merchant acceptance. So how do you acquire as many merchants as quickly as possible and ahead of your competitors to build out that network. And that's basically what Klarna and AfterPay are doing. And heck, in Australia, there's probably another 10 smaller buy now pay later companies that are listed that just shows you how easy it is to create a business like this. But the moat is really around acquiring merchants and then at the same time getting those merchants to stick with you and creating an effect inside of the merchants, too. And that's what's unique to AfterPay, because they specialize in fashion, beauty, cosmetics, health, like HomeGoods, what have you. These are emotional purchase type categories, right? They're also lower dollar value type of categories. Generally, AfterPay, their basket sizes are like one hundred to one fifty dollars. And their outstanding balances are only slightly higher than that. And so, at any given time, the consumer doesn't carry that much of college debt with them. And if you look at the usage frequency of it, their most mature cohorts in their most mature market of Australia are like twenty-five. People use it twenty-five times a year.

It's actually some of them are pushing close to 30 in the US, cohorts are following actually a similar but actually even quicker trend than what you're seeing in Australia. They're seeing consumer behavior in the US is very similar to that in Australia. That's the real difference between AfterPay and the other platforms, is that customers have really strong loyalty to the actual payment provider. So, for instance, during Covid, a lot of people couldn't make their payments. And what happened was that these customers will proactively call up AfterPay and be like, hey, I'm having some financial difficulty. I know that I won't be able to make my next payment. Can we work something out? If you hate your payments provider, let's say you hate Visa or you hate your bank. They're never going to proactively call them and say, I'm going to miss a payment. You're just going to miss it. But by having the customers proactively call, one

shows the brand loyalty towards it. And, you know, there are some surveys out there that indicate that AfterPay's NPS has the highest score among almost every digital payment provider out there in Australia, in addition to a large bulk of consumers. If a retailer doesn't offer AfterPay, they or any buy now pay later provider, they just won't make that transaction out.

Because the product that they're buying, say a new dress, a new thing, a make-up, it's not a necessity. And so, they're really buying it because it's an emotional purchase and an impulse purchase. And they want to use AfterPay in order to complete the transaction. But if they can't, then they will just abandon that altogether. And really, because fashion is more emotional category, it's what drives the merchants to get, you know, 20 percent higher. The basket's 20 percent higher conversion. They give free leads to their merchants. So, it really benefits everyone inside of this ecosystem. It allows consumers who don't have access to credit because they never had a credit card in order to make larger purchases and pay it off over six weeks. It allows merchants to go after these customers because when you extend credit to your customers, obviously, they're able to make larger purchases than what the amount of money that's sitting in their bank account. And so, it increases their basket sizes, increases conversion as well. And then within merchants also, there's really an effect. You know, if you're a fashion retailer and your competitor is using Afterpay, you're going to have FOMO and say, why aren't I using Afterpay as well? You know, why are all my competitors using it, I'm missing out on something and so they subscribe to it. And so, as you get larger, as you get more popular among the merchant side of the network, it actually kind of accelerates your growth also.

Aaron: So, what happens if like Apple or Amazon or, you know, Facebook comes out with their version of AfterPay or some kind of buy now pay later and you just click through? I only briefly looked at this, so, you know, excuse me if this is a dumb question. How does AfterPay respond to one of the tech behemoths saying, hey, this is a really good business?

Fred: So, I'll say this, that AfterPay is different than the rest of the industry based upon the categories that they focus on, fashion and beauty and cosmetics is a really different category than everything else. Now, it's part of the PayPal's broader offering to merchants that, number one, they aren't really focusing on it. They aren't really marketing it. They aren't really educating consumers on it. It's just one offering that they have inside of their staple of products. That's number one. The other thing is that you see a lot of these popular providers going after basically any retailer that is willing to take them, right? They will sell groceries along with car tires. They will sell your dentist the dentist services, along with whatever else. That's a problem, because

when you need to plaster your simple logo all over a retailer's item description page just to make the product work right. So, a little background about it is like, for instance, if you go to, like, beauty website, you're going to see the AfterPay logo on the checkout page, along with Visa, MasterCard and what you're going to see it on the actual product description page where it talks about the product. It gives you the price that you have to buy product, buy button, and then you After pay underneath it, you know, instead of paying one hundred bucks, pay in forward twenty-five dollars each installment.

Aaron: And is that because there's like a brand value there where consumer and they've built such a…it's almost like are you kind of making the present Afterpay at least in Australia is more of like, hey, I'm not going to make a copy on my copy machine, I'm going to make a Xerox or is it that kind of thing where you think AfterPay has become like a verb. And so, it's important to the product sale for it to be on the page?

Fred: Well, that's true. That's absolutely true. But in this case, why they put the logo on the item description page is different. It's because if you are contemplating buying this, you know, you know this particular makeup brand, but it costs one hundred dollars. You don't have one hundred dollars in your bank account, then you might abandon the cart. And go elsewhere or just stop shopping in general. But if you see the AfterPay logo and it says to pay for it you only need to pay four instalments at twenty-five dollars, you're like, oh, that's affordable. You're going to add that to your cart and you and because mentally you're thinking that you only need to pay twenty-five dollars, maybe you'll add a couple other things in the cart because you know you're going to get paid in two weeks and your paycheck is coming. That's, that's really the difference. And it's true for, say, Klarna, one of their competitor's logos are also on the item description page. But because it's on the item description page, the brands themselves, the retailers care about, like what does the payment provider actually stand for? What are the values of this company? They need to make sure that the retailers fashion brands brand values align with Afterpay as well. They don't want to have a provider that sells groceries or sells car tires, also selling thousand-dollar dresses alongside of them. And they don't want to clutter that page as well with ten different options, although some fashion companies do that. So, yeah, I'd say that's the that's the main difference there.

Aaron: So how do you think about AfterPay now? In terms of where it's at versus where it's going, like in terms of like how I'm thinking about value going back to our conversation on valuing free options.

Fred: Yeah, I'll say when we originally bought it, we basically bought it at the value of the Australian business. And like I said, the US business was for free and nowadays it's trading in the high 20s in terms of billion-dollar valuation.

You're definitely going to get multiple compression because at a mature multiple for this business, it's going to be a lower multiple than we're trading today. So, you have to be confident in the US market rollout. And so far, the trajectory is on track to basically for our thesis to play out in the US market and over the next five years. Yes, you will get multiple compression because of that, because it's starting from a higher place today than it was when we bought it. But at the same time, I have more confidence that it's going to work in the US based on the data that we're seeing. And so, you know, if it's successful in five years, the earnings growth will basically outpace that of the multiple compression. So, you're still going to get a pretty attractive IRR.

Aaron: Got it. So, there's still upside here based on what you're saying.

Fred: Yes, as long as we are correct and so far, it looks like the numbers are trending in the right direction.

Aaron: And so, this kind of gets me to a question that I can hear the excitement of just what you saw with AfterPay. It sounds like you're looking more qualitatively than just quantitatively screening or looking for value. Can you tell me what gets you excited and kind of what you're looking for in a prospective investor?

Fred: I think it's always different by company and industry, right? If you're looking at a gaming company, it's going to be very different than e-commerce, say, using e-commerce as an example, just studying the entire industry. We have a thesis about what makes e-commerce companies work.

For instance, one of the high-level things that attract me is that if it's a female dominated shopper base, that's usually very attractive because females are the majority of, make up the bulk of retail spending, especially in the high margin category such as fashion, furniture, beauty, cosmetics, what have you in addition to females tend to shop more frequently as well. And what happens with a younger business is that you really want a sticky product. You want shoppers coming

back to your platform every day or every week and purchasing five times a month versus males tend to buy a larger, higher value commodities product such as electronics small, you know, smartphones, TVs, cars, what have you. These purchases are made say once a year.

And so, when you have an e-commerce platform geared towards males, you have to continually reacquire that customer. When they are looking for a new smartphone or they're looking for, you know, a new Nintendo or whatever, that makes your business harder to scale, especially at an earlier level, as opposed to having a very sticky customer base that just naturally comes back to your platform, say, once a week or so. So, they're constantly reminded that your business exists. And so, when they are ready to make a purchase, which happens to be multiple times a month, they will make it through to your platform. So that's one. And so, if you think about the sequence of events that has to happen in order for a company to become very attractive and highly profitable, usually it's like having really a high engagement with it with a company. Right. How many times do you open the app? How long do you spend inside of this app versus competitors?

And that usually leads to, say, usage, frequency and purchase frequency. The more times you visit this app, it's almost like visiting a mall, right? If you go to this mall 10 times a day. Some people open these apps 10 times a day, maybe in a given week. So, you went to this place 70 times over 70 trips. You're going to find something that appeals to you. And so that drives purchase frequency. And usually that will happen many times a month as long as the engagement is up there. And because you're purchasing more frequently, that revenues are more robust because it's coming from a sticky customer base and that those revenues give you basically cash to go reinvest back into your business, to scale up to market, to launch different promos, to generate virality for this product, get you towards that critical mass. And when you hit that critical mass in self sustainability in terms of the business is actually generating enough profits to sustain it. That's when you kind of see a rerating in the business. I'd say at the very, very top of the funnel you're really looking for high engagement, which then leads to high usage, which then leads the revenues to reinvestment, which leads to profits. And so that's the sequence of events.

Aaron: When you try to look for those ideas, it's just coming from, looking at the universe of stocks that's available, talking to people, finding out who are the leaders and various categories? How does the inflow (of ideas) come to you?

Fred: Yeah, it's chaos when it comes to the amount of information, it's like overwhelming.

Yeah, absolutely. Comes from everywhere. I think you need to find, you know, quote unquote: where the leading indicators. It might be people. It might be like you talked to this one person. This guy is always like an early trend spotter or something.

And so, you talk to him. I might be talking to competitors of different companies. They're just keeping your ears really close to the ground, what's happening inside of industry. And so, you might continue to read about this new company that's popping up and all these articles journalists are talking about whatever. And then you start again, you realize there's something there. So that's something to keep an eye on. Yeah. Where ideas come from is completely chaotic and random, honestly.

Aaron: How do you think about sizing of positions, when you know you're super excited? Let's go back to, April, May and it was amazing in your letter, you're literally up four percent for the first quarter, which is an amazing return considering what's going on. But you put out a call, you're like there is an opportunity here. And how do you think about putting that money to work in like a Sea Limited or Afterpay? How do you size that? Can you talk about just like how you think about that?

Fred: Yeah, we actually called capital on April 3rd.

Aaron: Yeah, we think alike. Actually, I just got back into the fund management business. I raced to launch a new small friends and family partnership on April 1st.

Fred: Very good timing. Yeah.

Fred: In terms of like how we build our positions, I mean at a high level, I just normally we start small, it's going to be towards the low end of our threshold, which is about a five percent position. That's where we usually start our positions. And the way that I think about this portfolio is that it really functions, as you know, with the power of the 80/20 rule. A handful of companies are going to drive the best performance of your portfolio. So, if you look at our Q4 2019 letter, I did a study of our historical holdings. We had made twenty-nine investments up until that point. But if you look at the top six investments, they are what drove like over one hundred percent of our returns up until that point. So, the other twenty-three investments basically netted out to zero.

So, the question is, how do you maximize the handful of companies that you're going to get right. And are going to drive the bulk of your performance to ensure that they can basically carry your entire portfolio? Every name that we're investing in, we're looking for them to return multiples of our investment and hopefully be able to return the entire fund, essentially. So, in that way, it's very similar to a growth equity or a late-stage venture fund. We're looking for companies that already have product market fit, that already have a sensible monetization model that actually matches the service they're providing or the product that they're providing. Some of these companies have a great product, but the monetization model and really what we're looking for, our companies that need gas to pour on the fire to get them towards that critical mass level.

And because of that, we have certain, like signposts for our thesis for what will get them to that point. And we're looking for indicators that our thesis is on track, you know, with typical venture funds that you may invest in a series A, but you're going to reserve some capital on the side for the companies that do work out, that are successful, that do gain traction with their customer base to be able to top it up on, say, on A on a series B on the C around on the ground and continually invest as it works. And eventually what happens is, like you have a handful of companies that basically return all of the returns for your fund. We operate in a similar manner. So, we start at like a five percent position because they are early-stage companies. That thesis may not be proven out. And so, we have capital mentally allocated to these companies or we know where the capital would come from as they hit certain thresholds or certain thesis points and as the companies progressed the way that we think they will, because these are winner take most types of companies again, the larger they become, the less risky the business becomes because they become more entrenched and pull away from all of their competitors, which allows them to also become a bigger position over time. It justifies making a larger position size because it is such a dominant flow company by that point.

Aaron: That's such a phenomenal model. You know, I've been listening to all these super successful venture capitalists on podcasts and had never thought of that (in the public markets). One of the things I personally had to learn about the investor is that you should actually (continue to) invest as a stock is going up if they're performing, because your winners will keep winning when it's the hardest thing to do in the world is to just keep buying, because to your point, it follows this power law effect. A company is winning, it's going to keep winning, especially in today's world with Internet knowledge-based companies where it is this winner take all.

Fred: It differs on the type of portfolio that you're running, the type of investor that you are, because if you're buying 50 cent dollars in that value is static. You're buying it based on hard asset value that that goes after the dollars that we're making.

Aaron: I love that idea. So how do you have like a limit, like, let's say, your stock goes up two to three hundred percent and do you just keep letting it rise or start trimming at some point?

Fred: Yes, I mean, we do have like a soft limit roll in terms, but it's based on cost basis rather than how large a position will be. And, you know, usually, in my view, that's the rational way to do it. Limit how much actual capital you put into this business. And for us it's about 15 percent, no more than 15 percent cost. We don't have any limits for how large a position will be. Because if you do have arbitrary limits, you will never let a position grow over 15 percent of your portfolio or over twenty five percent, that basically kills that kind of power law dynamic early on. You want your rules to match with the way that your portfolio actually functions. You want to maximize the returns of the ones that are successful.

Aaron: Do you short sell?

Fred: So yeah, we have the ability to, but I don't envision using that at any point in time hopefully.

Aaron: Do you ever see yourself saying like hey, there is some risk in this one geographic. So, we might be short. Indonesian stock market through an ETF, do you ever see that making sense or not really?

Fred: Probably not, unless there's a big event where we have a big edge around such as Covid this year, right? I would say ninety five percent of the time we're along only about five percent of the time we will put on hedges. And so, for instance, we started hedging back in February of this year around Covid, when literally no one was paying attention. I've had friends come from Hong Kong back in January and they were like buying up masks in New York to ship back to China. I shipped back about like four hundred masks and N95 masks back to my family in China back at the end of January as well. So, we knew exactly what was happening. And, you know, my family was locked down for six weeks already, kind of by that point. And I think most US investors, especially in New York, just walking around in New York, I think most people were oblivious, which gave us a larger edge.

It was a big event that people weren't paying attention to, which allowed, gave me the confidence to go out and hedge our portfolio because the market was still hitting, I think, all-time highs at that point back in February and volatility was low. So hedging was cheap.

Aaron: May I ask, I only have your numbers through September 30th, of one hundred and sixty four percent. Are you able to share like roughly where you're at now or do you want to just wait until you report?

Fred: Either way, I'd prefer to wait until we report. But it is higher than this.

Aaron: And this gets to a question. As a money manager reporting to investors, and you made reference to it before that you feel like you have not proven yourself yet. Do you have any worries or feel psychological pressure to just kind of show that this year's performance is not a one-time occurrence? And how do you think about setting investor expectations? What do you say to others who think: “oh, he's the star of this year, I can't wait for him to struggle next year?” Investing is so much a psychological game. And I really would be very curious of how you're thinking about that.

Fred: Yeah, I think the sequence of returns is random. I can't predict like what type of returns we're going to have next year or the year after or any given year. All I know is that our companies are going to be multiples more valuable in five years or ten years. Whether all those returns come in year five or whether they're like evenly spaced from here until then, I have no idea. I also tell our partners, every single one of them, that I promise you one day your portfolio will be down 50 percent. Peak to trough I guarantee it to you. You have to be mentally prepared for that and be emotionally stable enough to know that going in. And how you would react to that situation if it occurred.

Aaron: I’m glad you said that because I'll never forget I was running a small fund in 2008/2009 in small cap value, and I had never given that talk to investors. And I'll never forget two investors coming, I was 100 percent long in March of 2009 and they came into my office personally, which they never did, and they begged for their money out because they couldn't take it anymore. And I begged them. I said, please, this is literally the worst time you could possibly pull out your money. And they were a pretty decent size of the portfolio. And I'll never forget, I

said, OK, you know, I wasn't using leverage and I had to sell close to 10 percent of my portfolio literally at the market low, at what would become one of the biggest market bottoms of all time

Fred: Yeah, exactly. Put them in that hypothetical scenario and have them actually visualize it. And see how they would react.

I'll say I hope our partners understand that this year was extraordinary and not to expect, you know, tripling your portfolio every year. That's just ridiculous. But I will say that what's interesting about this whole event around Covid is that given our businesses that we invest in and this is definitely not true for the entire market or every portfolio out there, but it's unique to our portfolio, is that because the demand basically pulled forward, that they got closer to their critical mass point much quicker. And that should have taken them three years. They're already there. And because these companies tend to accelerate once they reach that point, because they now have tapped into…call it the mainstream. There is a viral effect. There is a winner take most effect there. So, they actually accelerate quicker than they did before that type of Covid event. And so, you may have had a company say, growing 20 percent beforehand because they had a great product. They were selling to the early adopters. But the majority of people that this product would be applicable for just didn't know about it. They didn't have enough of a budget to go market to those people to build the brand awareness. And so most people who would have found value and decided just didn't know about it before. Well, now you have this pull forward effect where you have a, say, three times, four times the number of consumers that are forced to use this product. Well, once you join and use this product, everyone loves it. Right? And then they will refer their friends to, hey, come try out the product. That's your customer acquisition. But at the same point, they have built enough brand awareness that basically the flywheel starts spinning quicker. Right. And so that gives you an acceleration of that growth.

So, probably some of our companies are reporting triple digit growth this year. That's not going to happen in future years. But what will happen is that you get to step up function and then you get a quicker baseline level of growth going forward than it did pre-Covid. That's the opportunity that we're seeing today, because you already got that step-up function. But it makes these businesses more durable. It got them to that critical mass level much quicker, which means justifiably, your multiples should expand in addition to the earnings power growing triple digits as well.

Aaron: This has been so great for me just to learn. I feel like I've learned so much. I'm really grateful for your time. This is phenomenal. I cannot wait to share this with people. So, thank you so much.