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Investment Insights from Silicon Valley

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*Source: Allianz Global Investors GmbH.

The WannaCry ransomware attack

This month saw a significant ransomware attack that affected hundreds of thousands of computers around the world, including the UK's National Health Service (NHS). The attack was a 'global wake-up call' for organisations to improve their security systems, according to the chief executive of UK-based software group Sophos, Kris Hagerman.

Sophos is our largest UK holding and we have long suggested that security would be a dominant theme over the next few years. Returns from the sector have been relatively lacklustre to date, but this attack puts it front and centre once again. As Hagerman said: "It's going to create a higher level of visibility and awareness among every size organisation, from the very largest to the very smallest".

This attack showed the vulnerability of some sectors, particularly if they are working on old PCs and haven't kept up with the patch fixes from software providers. It also shows that any good defence has multiple layers. Companies don't just need anti-virus software, for example, to catch malicious email, but several levels of protection. Defending against this type of attack is an ongoing process because the hackers are always innovating. Investment is a necessity; companies have to continue to spend money on their defences.

The more this type of incident happens, the more people focus on what security means. Hospitals are often using old computers, but this doesn't mean they can't get an email service to protect their systems. It costs relatively little to do so. With this latest incident, the consensus is that it was a test; that the attackers were probing the defences to see what was possible, but it is possible to see more ahead.

A problem of valuation

The US stock market has historically traded at a premium to other markets, but rising interest rates and a mature recovery has led some to question the gap between US valuations and those in the rest of the world. We are cognisant of the risks, but looking at the aggregate valuation of the US market does not necessarily paint the whole picture.

We are taking a barbell approach in the trust. This means that we incorporate some stocks that trade on relatively modest valuations, such as the semiconductor companies. For these companies, investors are sceptical about the duration of the economic recovery and are pushing prices lower. We believe the recovery still has some way to go and that these companies merit a higher rating.

That said, we also have some stocks in the portfolio that trade on very high multiples of earnings. To our mind, it is a mistake to look simply at the earnings multiple. We believe it is more informative to look at whether earnings are keeping pace with expectations. This means we are also comfortable holding companies that are on the cusp of profitability, such as some of the software-as-a-service or security companies. For these companies, the multiples look extremely high, but earnings are rising sharply and.

Allianz Global Investors

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The biggest risk is where valuations are high, but earnings are not keeping pace. We would be wary where growth is barely in double-digits, but market expectations are inflated. There are plenty of this type of company around. We would also be wary of those companies on the wrong side of history, such as some hardware and traditional software businesses, or those selling into low growth areas such as telecoms.

Investors should not forget that technology is a global business, and should be a significant beneficiary of the growth around the world. Therefore, the US economy is far from the only consideration.

Rising rates

Another consequence of an increasingly mature economy is that interest rates are rising. The Fed funds rate now sits at 1%, and there is widespread expectation of two more rate rises before the end of the year. Stock markets have been pushed higher by loose monetary policy, so it is reasonable to ask whether they will suffer as rates rise.

Within technology, there are some companies that appear vulnerable because they have taken on a lot of debt to buy other companies. However, many of these companies have seen better-than-expected cash flow, which is allowing them to pay down this debt faster. The real concern is for those companies where there aren't strong enough cash flows to back up the debt. They are likely to struggle as rates rise.

It is worth remembering that higher rates are only a response to stronger growth, and there are some advantages to higher rates. We believe it may encourage some companies to spend money on projects with a long-term payoff. For example, with human capital management, a lower unemployment rate means that companies have to focus on managing people better, on retention, and on managing overtime. The environment can stimulate better behaviour and therefore investment-led growth.

Apple versus its suppliers

Apple remains the largest holding in the trust and is now a mature business. There is not a lot of growth left in mobile phones in the developed world, which has left it reliant on the replacement market. This part of its business is robust, but Apple wants to do more innovation to make its product more useful. This includes developing a better camera and a more robust screen plus other bells and whistles. This is likely to push up the price of the phone and has plunged Apple into dispute with a number of its suppliers.

At the moment, Apple pays some of its suppliers a percentage royalty, based on the price of the phone. Apple argues that these suppliers should not be reaping the benefits of developments that are nothing to do with them. If the additional value of the phone is coming from the improved screen or better camera, this has nothing to do with the network and Apple believes it shouldn't have to pay out. This is an important dispute and its resolution could shape Apple's future relationship with its suppliers and have important implications for its cost base.

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