Investment insights from Silicon Valley

An investor's view of the latest tech trends and challenges in 2022

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AUGUST 2022

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With decades of experience of investing in technology companies, the San Francisco based Global Technology Team has witnessed the evolution of the technology sector from the birth of the personal computer to the arrival of the internet and now the shift to cloud computing. The team's San Francisco location puts them in close proximity to many of the world's most innovative companies. The Global Technology Team manages US$11 billion* in assets.

*Source:
Allianz Global Investors GmbH.

Re-evaluating technology

Investors will not need reminding that this has been a tough period for the technology sector. A combination of weaker earnings, rising interest rates and a fragile economy has seen investors reappraise the sector. Strong companies have been pulled down with weaker companies amid an uncertain and unpredictable climate.

The sector has moved a long way very quickly and the pressing question today is, when might this sell-off end. There is undoubtedly a relationship with the interest rate cycle. The technology sector took off dramatically as rates fell and the reversal of monetary policy has contributed to its fall. However, we believe valuations now realistically reflect the likelihood and magnitude of further rate rises.

The real unknown is on the direction of corporate earnings. Certainly, there are operational challenges. Most technology companies are slowing hiring and we see companies reversing or decelerating some of their investment in facilities. The Dollar has been very strong, which has hurt companies with worldwide earnings such as Microsoft. There are a lot of moving parts. Having adjusted for higher interest rates, markets are wrestling with the idea they may also need to adjust for lower earnings.

There has already been some adjustment lower and in some cases, it may be necessary to move lower still. The mega-caps, for example, as they are so large, are unlikely to remain immune to any economic slowdown. However, we can still find companies geared to long-term structural trends, such as digitisation or cyber security, where earnings are robust and there is good visibility into the future. The turning point for the sector as a whole is difficult to predict, but investors can't ignore the compelling growth on offer from parts of the technology sector indefinitely.

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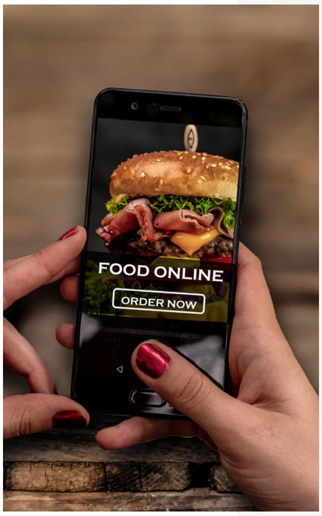
Labour replacement



The labour market has been the one bright spot in an otherwise shaky economic picture. In the UK, the number of full-time employees is at an all-time high, while the number of job vacancies rose to a record 1.3m[1] . The US labour market added 390,000 jobs in May, while the jobless rate is back down to pre-pandemic levels[2].

While this is welcome – and should help to stave off stagflation – it creates pressures for businesses. It is becoming more difficult to recruit, particularly in low wage sectors such as leisure or travel. Increasingly, we see the hardest hit industries turning to technology to manage their labour problems.

Companies are worried about imminent recession and are having to prioritise technology projects. Figuring out a way to interact with their customers better, or improving distribution are now high priority items, along with cost saving or cybersecurity projects. As part of this, online ordering systems for restaurants are increasingly widely used, which helps restaurants run with fewer waiting staff. We also see stores moving to self-checkout options as they can't hire enough till operators. Amazon takes this one-step further with its video checking systems, where shoppers simply help themselves and purchases are charged to their card when they leave. We believe this is a pattern that will build over time as companies recognise the productivity gains that can be achieved.

Tesla: the 's' in ESG

To the surprise of many investors – and Elon Musk himself – Tesla was dropped from the S&P 500 ESG index in May. Musk described it as "a clear case of wacktivism" on Twitter. The reality is more nuanced. Tesla was caught up in an increasing focus on the social impact of companies, with concerns over practices at one of its manufacturing plants.

This is a concern: we monitor environmental, social and governance issues closely for all our holdings. We have been visiting the Tesla factories for over a decade. They are certainly tough places to work. They need to be. To compete with super-efficient Chinese or Korean factories, they have to be highly productive environments where everyone works hard. In general, we have found that they operate with extremely high standards and reward hard work.

They also operate with an innovative structure, whereby engineers are on the shop floor. This integrated structure helps improve productivity because those who design the systems can immediately see where any problems lie in the production process. This system puts Tesla some way ahead of other manufacturers that don't have that integration.

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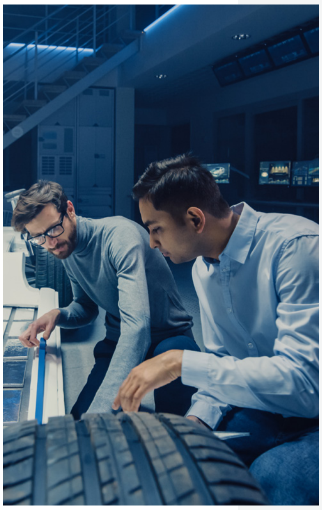

It has helped it manage the chip shortage, for example. Tesla has been able to identify where chips are being used and where not, and then adapt its production process. It has just taken delivery of a state-of-the-art casting machine that it will use in making the Cybertruck rear differential. Rather than using 30 robots to weld the various parts, this helps build a much more durable product at lower cost.

However, S&P's move does send a signal that companies need to tread carefully on social issues. Investors increasingly want the companies in which they invest to show leadership in areas such as employee well-being, diversity and labour rights. It is becoming intricately bound with their reputation and licence to operate. All technology companies need to look at their practices in light of this shift.

New advertising models?

As the economy weakens and privacy concerns become increasingly pressing, the advertising-led business model adopted by many of the social media groups appears increasingly vulnerable. Meta is already seeing the slowest growth rate in its history. However, will it prompt companies to reconsider their business models?

There are some signs of those businesses that have been predominantly advertising-led – like Meta and Google – trying alternative approaches. Meta is trying to build a different universe in which people will live. Within that universe, the company hopes, people will buy lots of items such as housing, clothing or cars. Meta will be the government of this new universe and will take a cut of those items. It is bold vision, but it is difficult to tell whether it will prove as compelling as Facebook.

Google, in contrast, has now built a vast ecosystem, including Youtube, Maps and Waze. Google places ads not just in search, but in maps or email and advertisers pay on results. This allows it to be extremely targeted in the service it offers to advertisers. The advertising can meet specific objectives. This model seems to work well and Google is currently getting a larger share of the advertising pie.

1. https://www.ft.com/content/812f3177-2d4d-47df-9c8a-919681f56946
2. https://www.ft.com/content/7690564b-5d6b-45fc-9cd6-ff2d54da8b29

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