Allianz Technology Trust

Summary

ATT offers a relatively pure exposure to companies involved in 'innovative disruption' in sectors as wide ranging as automobiles, advertising, security, retail and web services.

Despite some clouds hanging over the technology sector's current leading names, the management team is highly enthusiastic about opportunities, with lead manager Walter Price commenting that "this is the best environment for technology investing for 15 years". He reports having more ideas than capital available.

Reflecting the team's optimism, the portfolio has witnessed a significant re-shaping since September 2017. It has shifted capital away from stocks viewed as 'growth at a reasonable price' and into 'high growth' stocks. This represents a marked change in risk appetite and the re-positioned portfolio now offers, according to Allianz Global Investors' (AllianzGI's) estimates, earnings growth for the next 12 months of 34%, more than twice that of the benchmark. We note that the number of holdings has increased from 57 stocks (in September 2017) to 64 (March 2018).

Walter and his team in San Francisco have developed a long-term track record stretching back several decades. They have managed ATT for over ten years now, over which period the trust has delivered NAV total returns of 440%, outperforming the benchmark by an exceptional 126 percentage points. Over the same period, Polar Capital Technology Trust's (PCT's) NAV has achieved returns of 374%, 66 percentage points behind ATT. Year-to-date, ATT is +5.6%, c.4.3% ahead of PCT, and 6.8% ahead of the benchmark, which is in negative territory. Walter attributes this outperformance to his off-benchmark (Amazon) and mid cap exposures.

ATT has assets of £348m. There are relatively few specialist tech funds in the UK trust and OEIC universe, but ATT has outperformed the vast majority of them.

Historically, ATT has traded on a wider discount than its closest listed peer, PCT. However, recently this situation has reversed and the trust trades on a small premium to NAV (of 1% at the time of writing) as compared to PCT's discount of 4%, reflecting the stronger performance and active stock picking employed by the AllianzGI team.

Portfolio

The technology sector is rarely far from the front pages in the financial titles. However, in recent weeks it has regularly been hitting the headlines in the mainstream press too. Amazon and Facebook have both been the subject of politicians' wrath, and share prices of each have lost some of their poise. At the same time, Tesla has been facing recurring questions about its finances, its production capabilities and the speed at which it has rolled out semi-autonomous driving.

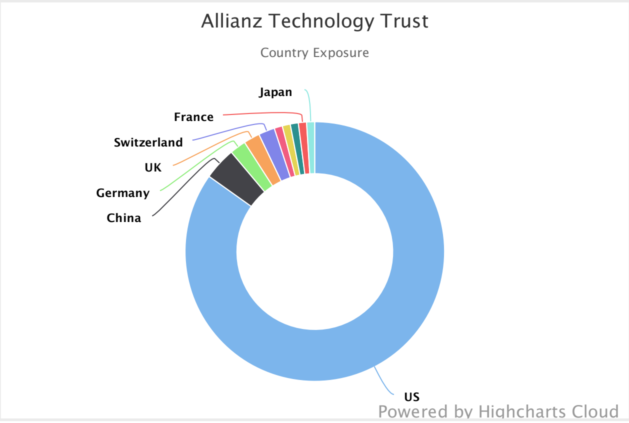
All of these companies are part of the ATT portfolio, and so when we spoke to lead manager Walter Price, getting his view on these stocks was at the top of our agenda.

In Walter's view, Facebook (and Alphabet) were due a period of consolidation in share price terms having had a very strong run. Walter had cut his exposure to both in the anticipation of the General Data Protection Regulation (GDPR) and an expectation that European authorities would look to try to protect traditional media companies within the EU from its onslaught. Walter believes that both companies will have to ramp up spending on vetting users and moderating content, but the tide towards targeted advertising is one that benefits both advertisers and consumers. As such, he believes this is one small step back in a relentless march forward for both companies. Walter and the team have used Facebook's travails to increase the weighting from c.1% in early 2018 to 2.7% of NAV (at end of March 2018), and they maintain a watching brief on both stocks with a view to potentially increasing exposure again when the picture becomes clearer.

As regards Amazon, Walter believes that US President Trump's accusations are unwarranted and the US Postal Service is not subsidising what is one of its biggest customers. He believes that Amazon has rejuvenated a business that was otherwise in terminal decline, in the process helping defray the huge pension costs that the US government would otherwise have had to meet for the postal services' enormous workforce. Amazon is an off-benchmark holding, as Dow Jones classifies Amazon as 'retail'. The team maintains a significant weight (7% of NAV), continuing to believe Amazon's advertising and cloud storage businesses have enormous growth potential.

Tesla also remains a holding. Walter believes that whilst production difficulties may be holding back immediate deliveries, the company's embedded expertise and integrated software will ensure that it keeps ahead of the incumbent competition.

The team's investment process seeks to identify areas of 'innovative disruption', and looks to invest in what it sees as the next 'mega cap' businesses. Despite some clouds hanging over the technology sector's current leading names, Walter is highly enthusiastic about opportunities, commenting that in his view this is the best environment for technology investing for 15 years. He reports having more ideas than capital available. We note that the number of holdings has increased from 57 stocks (in September 2017) to 64 (March 2018), mainly in the US, but with selected exposures elsewhere.

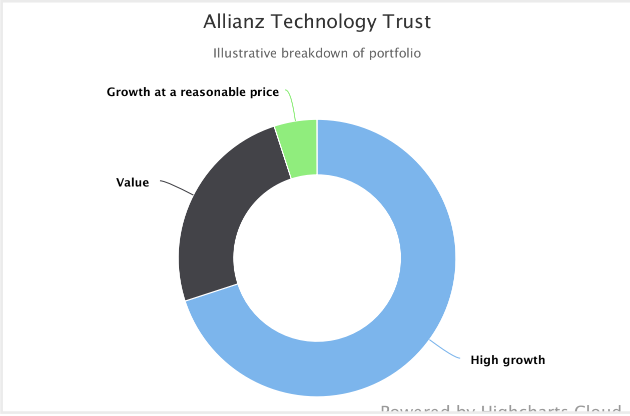


Source: Allianz Global Investors

In Walter's view, several factors underlie the team's bullishness. Technology companies are amongst the biggest beneficiaries of the tax bill to repatriate cash, but technology company customers are also benefiting from the immediate ability to write off capex against tax. He believes many companies will use this opportunity to invest in the move to a cloud infrastructure, therefore cushioning the one-off costs and setting themselves up for significant cost reductions in the years ahead. Another enduring trend he sees is the rejuvenation being witnessed in operations and manufacturing facilities around the world, perhaps spurred by the US/China trade tariffs, but in any event a feature because of the rise of robotics and increasing labour costs in traditional 'low-cost' centres such as China.

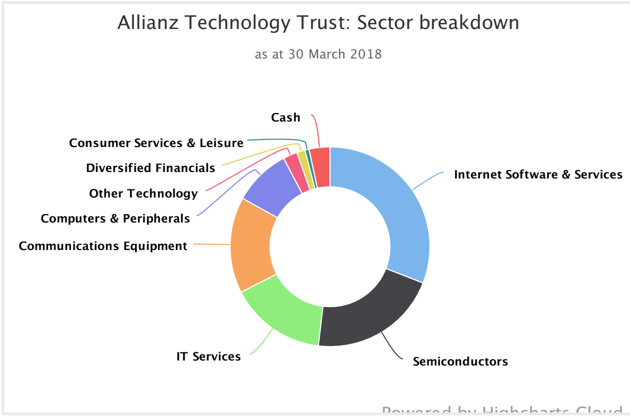
The team has been consciously expanding exposure to companies outside the US, recognising that there are future leaders and disruptors all around the world. US companies still retain a very dominant position. In Walter's view, one reason for this is that US investors are willing to take a longer view on technology companies than their counterparts in Europe. The direct result of this is the concentration of highly successful US technology companies – particularly in his backyard, near San Francisco. In his view, these companies have achieved scale and market dominance quicker than their European counterparts as a result of US investors' willingness to look at revenue rather than profits as a measure of success. There are exceptions of course, and the team holds one UK AIM-listed company, Blue Prism, which develops robotic software that helps improve productivity of office staff. We note that it is only one of two companies (the other being Tesla) in the portfolio currently that has never made a profit, the rest being profitable, 'real' businesses.

The portfolio has witnessed a significant re-shaping since we last wrote on the trust in September 2017. Since then, it has shifted capital away from stocks viewed as 'growth at a reasonable price' (GARP), and into 'high growth' stocks. Six months ago, the team had around a third of the trust's assets in each bucket, and so this represents a marked change in risk appetite. The only significant remaining GARP stocks are Microsoft and Alphabet. The re-positioned portfolio now offers (according to AllianzGI's estimates) earnings growth for the next 12 months of 34%, more than twice that of the benchmark. In terms of valuations, the portfolio is currently trading at a 12-month forecast P/E of 29x, relative to the benchmark P/E of 17x.



Source: Allianz Global Investors

Within 'high-growth', the team has increased its weighting towards cloud businesses, which has meant a significant increase in the proportion of the portfolio invested in mid caps. In Walter's view, these companies are 'purer' in their exposure to the cloud. Companies it continues to own in this category include Salesforce.com, ServiceNow and Paycom Software, and it has added HubSpot, Tableau Software, Okta and RealPage. Other



Source: Allianz Global Investors

high growth areas in which ATT has investments are AI, robotics and laser cutting technology.

'Value' is an area of the market that, over the past three to four years, the team has been increasingly happy to embrace. The strong returns achieved from this part of the portfolio has shown Walter and his colleagues that at times, technology investing isn't about selecting the highest growth stocks in absolute terms. Within the value bucket, the team has recently cut exposure to semi-conductors, selling out of Applied Materials and switching Samsung into Micron, which is trading on a 5x multiple of forward earnings. In the team's view, prices don't reflect the changes in the semi-conductor sector that have occurred in the past few years. It believes that margins in this sector should double in the next few years, reflecting the consolidation that has happened in the space given the ever-increasing capex requirements.

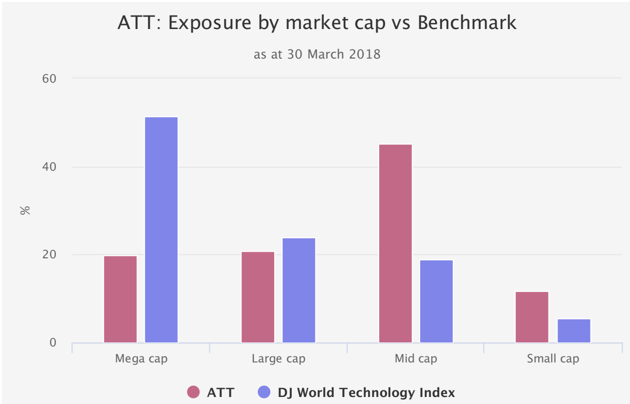
TOP TEN HOLDINGS

HOLDING	% NAV
Amazon.com Inc	7.00
Microsoft Corp	4.51
ServiceNow Inc	3.97
Palo Alto Networks Inc	3.52
Square Inc	3.49
Netflix Inc	3.48
Arista Networks Inc	3.00
Micron Technology Inc	2.96
DXC Technology Co	2.73
Facebook Inc	2.67
Subtotal	37.33

Source: Allianz Global Investors (31.03.2018)

Relative to the benchmark and closest comparison in the investment trust universe, Polar Capital Technology (PCT), the trust continues to have a large underweight to 'mega cap' names and a big overweight towards mid cap. Relative to PCT, the trust is significantly more concentrated (64 vs c.109 stocks). Walter and the team continue to believe that they have a competitive advantage in being located in the San Francisco Bay Area, where seven out of the top-ten largest technology companies in the US are based. They believe that being on the doorstep is a huge help in being ahead of the crowd in identifying the world's most innovative companies.

In terms of outlook, the team believes that whilst the technology sector has had a strong rally in recent years, it is significantly stronger today than when compared to the technology bubble at the turn of the century. The recent performance has been driven mostly by actual earnings and cashflow growth rather than just multiple expansion or hype. Technology valuations are not excessive compared to the broad markets; tech companies are generating significant cash-flow and many large tech companies are returning cash to shareholders. As the sector has matured over the past two decades, the team believes its risk/reward profile is far more attractive today. It believes that multiple secular growth opportunities, along with the widespread need for enterprises to upgrade IT systems, provide a compelling backdrop for specialised active managers in technology.



Source: Allianz Global Investors

Gearing

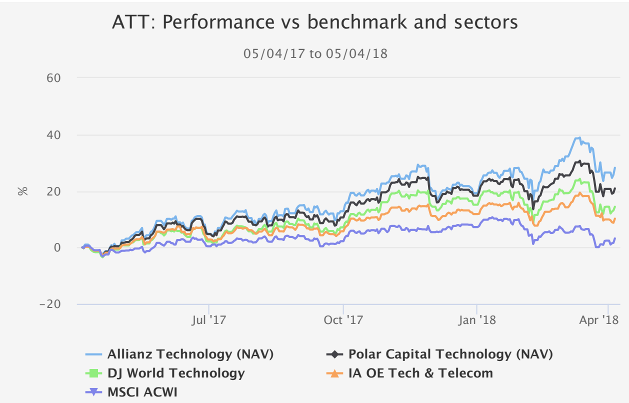
The trust does not currently have a gearing facility in place. However, ATT does have the flexibility to employ gearing. The self-imposed limits are a maximum of 20%, although wouldn't be expected to exceed 10% of net assets. Similarly, the proportion of the company's net assets held in cash or liquid investments will not exceed 15% of net assets but may be increased at times to a maximum of 30%.

Returns

The onward march of technology stocks looked unstoppable, even after the market volatility in February in which the FAANG (Facebook, Apple, Amazon, Netflix and Google parent Alphabet) stocks posted much smaller declines than the rest of the market. More recently however, the picture has become less clear, with political and regulatory issues surrounding Facebook and Amazon, leading to a marked sell-off in those stocks.

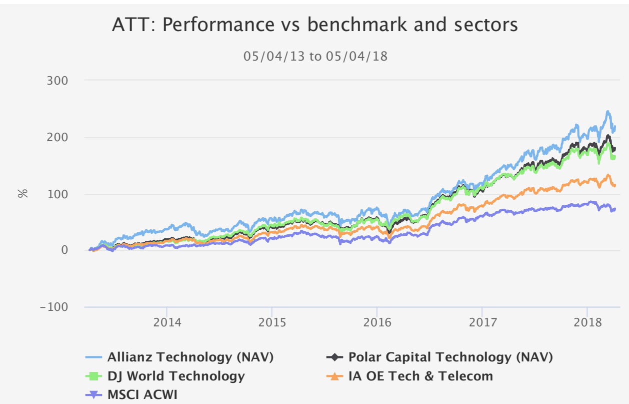
As we have discussed, the ATT team expects earnings growth of 34% for the next 12 months for its portfolio and has been building up the trust's allocation to growth stocks. At the same time, it has around 30% in value names, which it continues to believe will act as a buffer should growth expectations suffer a shock, or the market suffers from an extraneous event.

Over the short term, as the graph below shows, despite a marked increase in volatility ATT has achieved good outperformance of PCT and benchmarks on a one-year basis. Much of the outperformance of PCT has come in the calendar-year-to-date (ATT +5.6%, vs PCT +1.3% to 16 April 2018). Walter attributes this outperformance to its off-benchmark (Amazon) and mid cap exposures.



Source: Morningstar

This strong showing over the past year is an extension of a much longer period of outperformance delivered by Walter and his team based in San Francisco. They have a long-term track record investing in the technology sector stretching back several decades. The team took over management of ATT over ten years ago (since May 2007), over which period the trust has generated NAV total returns of 440%, outperforming the benchmark by an exceptional 126 percentage points. Over the same period, PCT's trust's NAV has achieved returns of 374%, 66 percentage points behind ATT but still way ahead of the benchmark. Over five years, the trust is up 219% relative to the benchmark return of 166% and PCT's return of 180%.

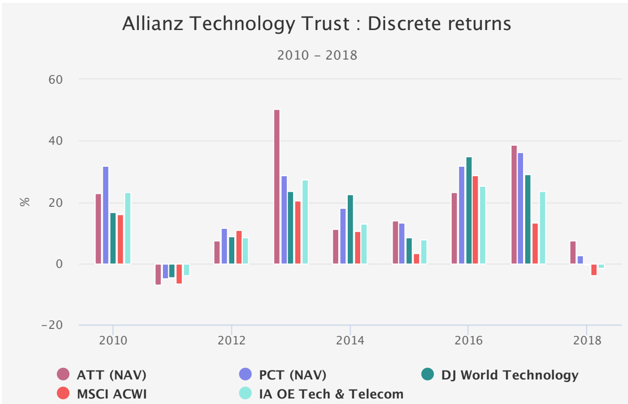


Source: Morningstar

The board monitors the company's performance against the wider universe of open-ended funds, closed-ended funds and exchange-traded funds. In the latest report and accounts, the board highlights that the performance of ATT versus the other funds within the Morningstar Global Technology Sector - Equity category is very strong over all periods. In the five years to 30 November 2017, ATT ranked first out of 58 funds and, over ten years, fourth out of 50.

Taking a pure stock picking approach, as Walter and the team do, means that strong outperformance will have to be weighed against periods of underperformance. The graph below illustrates the last few years' relative performance against wider equity markets but also the benchmark and the open-ended peer indices provided by Morningstar. 2013 was a standout year thanks to the team's very high mid cap weighting. This mid cap exposure had the opposite effect during 2014 and 2016, when the trust underperformed the benchmark due to an underweight position in large cap stocks. During 2018 it would appear that mid caps have once again ridden to the rescue, helping to deliver strong outperformance of PCT and the benchmark.

The managers try to mitigate the downside by spreading risks and moving the portfolio away from more volatile mid caps or themes at times in the cycle – with the continued increase in the allocation towards 'value' being a case in point. Despite this, it is worth noting that the trust is likely to be more volatile than other more generalist peers which do not have a sector specialism.



Source: Morningstar

Dividend

The trust does not pay a dividend, and we understand it is currently not the board's intention to do so.

Management

Walter Price and Huachen Chen lead the specialist team of four portfolio managers. They have been investing in technology companies for over 35 years and Walter has worked with co-manager Chen for over 30 years. The team now has a full ten-year track record for this investment trust, having won the mandate for ATT in 2007. It has consistently applied the same approach to its investment research, looking for disruptive innovators that can generate strong returns for investors from 'creative destruction'.

The team lives and work in the San Francisco area where a great number of the world's technology companies are located, a factor which it views as essential for quickly identifying changes in relentlessly competitive markets. In aiming to identify major trends, the team believes that since the mid-1980s they have correctly identified new trends in PCs, networking, wireless communications, storage systems, the internet and cloud computing – all ahead of the crowd.

The team follows the same investment rationale that it has done for many years. They aim to identify major trends ahead of others, investing in stocks that have the potential to become tomorrow's Microsoft, Cisco or Apple. The team believe in having a relatively concentrated portfolio and a bias towards mid caps (plus underweight large caps relative to the benchmark). The team also leans on AllianzGI's proprietary Grassroots Research network, which enables it to commission reports and market research from journalists, analysts and other professionals, which has in the past proved useful with consumer related products.

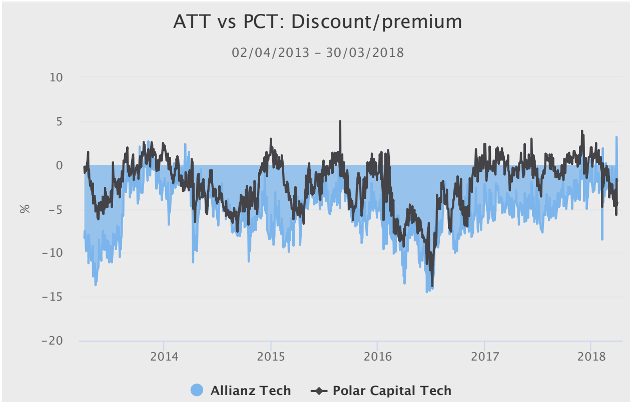
Discount

As the graph below shows, ATT has traditionally traded at a modest discount to PCT, its closest rival, which is more than four times larger (and therefore theoretically more liquid). This picture has somewhat reversed since the start of 2018, with PCT suffering something of a de-rating and ATT now trades at a premium to PCT.

We would caution that discounts for sector specialist trusts can be fairly volatile given that at times they reflect sector views rather than those on a specific trust. As such, the PCT discount may reflect a wave of retail profit-taking rather than the market reflecting the superior performance delivered by ATT.

ATT has been re-issuing shares from treasury for the past six months or so. The articles of association allow the company to re-issue shares previously bought back at a small discount subject to a variety of parameters set by the board. In October 2017 the company had 2.3 million shares available to be issued, and most recently (17 April 2018) these had all been reissued. This has meant that c.£26m worth of treasury stock was sold at modest discounts during 2017 and early 2018. More recently, the company applied for a further 2.5m shares to be issued where required, which will only be issued at a premium to NAV. So far the company has issued c.£3m worth of these new shares at a slight premium.

Whilst the discount has been going the right way, the board does look to try to manage the discount volatility on the downside. It has stated that it will look to buy shares back when "the discount is wider than 7% and where there is demand in the market for them to do so". This discount control mechanism (DCM) has helped ensure that the rating has remained relatively stable over time. It is worth noting from the graph above that in more difficult market periods the discount has widened out to a level approaching (and sometime surpassing) 10%. Sharehoders have the opportunity to vote at the AGM at five-year intervals whether to continue the company. The next continuation vote will be in April 2021.



Source: Morningstar

Charges

The trust has a fixed investment management fee of 0.8% of its market capitalisation up to £400m, and 0.6% of market capitalisation above £400m. At the current time, with a market capitalisation of £348m, the fee remains at the higher level. The company's OCF in the last financial year (2017) was 1%.

In addition to the management fee, AllianzGI is also paid a performance fee calculated as 12.5% of outperformance of the NAV against the benchmark. The performance fee element is capped at a maximum of 2.25% of the trust's NAV at the year's end. Importantly, a performance fee will only be paid if its NAV is higher than that at which any previous performance fee was paid and if performance in that year is also ahead of the benchmark on a cumulative basis. In this way, the team has to make up any under-performance from previous years before any performance fee is due.

This compares favourably against PCT, which has a management fee of 1% up to £800m and 0.85% above £800m, with 0.8% on net assets over £1.7bn and a performance fee of 15%.

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