Allianz Technology Trust

Update
29 March 2019

Summary

For investors wanting exposure to this growth, Allianz Technology Trust (ATT) represents a very actively managed specialist investment trust, managed by one of the most experienced technology investment teams in the world, which has delivered excellent returns over the years.

The team seek to identify areas of 'innovative disruption' and invest in the businesses best placed to exploit it. At any one time, the portfolio comprises between 50 and 70 stocks, currently at the high end of that range at 70. We caught up with Walter Price, manager of the trust, recently to discuss current positioning.

Walter's biggest theme in the portfolio is to cloud and SaaS businesses, which together amount to around 40-50% of the portfolio (including Microsoft, Google and Amazon), but mainly represented by holdings in 15 or 20 mid-cap cloud software companies. In Walter's view, 2019 is the best environment we have so far seen for selling cloud software, with many companies set to achieve exceptionally strong sales and earnings growth.

The mandate for ATT is very flexible, and the team seek to ensure that the portfolio always reflects their views on the technology market at any one time, with very little regard to benchmark weightings. At times, this positioning has been reflected by a significant proportion of the portfolio being in mega-cap stocks, but at other times (such as now) it is invested more heavily in mid-caps. Currently, this means ATT is differentiated to Polar Capital Technology Trust as well as the benchmark, which both have a much higher weighting to mega-cap stocks.

2019 has seen a strong rebound from the volatility of Q4 2018. Walter's exposure to mid-cap stocks - upped markedly since early 2018 - has meant that ATT has been in a strong position to perform so far in 2019. Over twelve months to 11th March 2019, ATT is up 12.2%, against the benchmark return (in GBP) of 5.6% and Polar Capital Technology Trust (PCT)'s return of 9.4%.

As it is currently positioned, the portfolio now offers, according to Allianz Global Investors' (AllianzGI's) estimates, a 3-5 year EPS growth estimate of 32% against 16% for the benchmark. Manager Walter Price is mindful of valuations, and whilst the portfolio is expensive on a forward P/E of 34.7 x, the realised PEG (or PE to Growth) ratio will be lower than the benchmark in the year ahead.

Walter and his team believe technology companies are better equipped than many other sectors to achieve growth irrespective of the market or economic backdrop. The focus on smaller, more innovative companies operating in a niche should, they hope, enable them to ride out what they accept is a possibly difficult year ahead.

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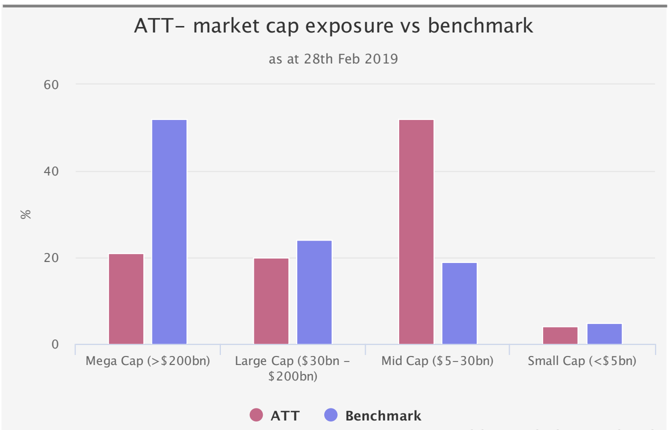
Portfolio

ATT's objective is to achieve long-term capital growth by investing in technology companies on a worldwide basis. Walter and the team set their stall out as trying to find the most innovative disruptors which have the potential to be the mega-caps of tomorrow. 2019 has so far been a strong year for ATT on a relative and absolute basis. As we discuss in the performance section it has outperformed the benchmark and peers by a hefty margin. We recently caught up with Walter Price who leads the management team to get some colour on how this has been achieved, and how the trust is currently positioned.

The team seek to ensure that the portfolio always reflects their views on the technology market at any one time, with very little regard to benchmark weightings. At times, this positioning has been reflected by a significant proportion of the portfolio being in mega-cap stocks, and indeed during 2017 this was a key driver to returns. However, as we picked up during a discussion almost a year ago and mentioned in our report on ATT at the time, the team made a conscious change, significantly increasing the proportion of the portfolio invested in mid-caps early in 2018.

Fig.1: Market Cap Breakdown



Source: Allianz Global Investors

As the graph above shows, the mid-cap exposure currently differentiates ATT from its closest peer – PCT - as well as the benchmark, which both have a much higher weighting to mega-cap stocks. Walter believes that this is one of the main contributors to performance being so strong this year, particularly given the mid-caps they have selected enable a relatively pure exposure to "the cloud", and / or Software as a Service (SaaS) business models. In Walter's view, these companies will continue to benefit from the more constrained environment for corporate spending, with business's transition to the cloud still very far from being completed. The managers believe that companies offering cloud solutions are likely to be relatively well insulated from an economic slowdown, given their customers are part way through a multi-year transition which will save them significant costs into the future. At the same time, the investment will allow them to operate much more effectively in the digital world. As such, Walter and the team believe cloud / SaaS businesses offer highly attractive growth characteristics with good visibility for the next 2-3 years.

It is worth noting that mega caps (over $200bn) remain a relatively small part of the portfolio at c 28%, compared to the benchmark which has exposure north of 50%. Walter exited the postion in Apple in early January 2019, recycling the proceeds into companies that he believes are in a very exciting niche supplying chips and components for electric vehicles. He owns several stocks in this area, including Cree which is a world leader in silicone carbide manufacturing. Silicone carbide chips allow electrical systems to run at a higher temperature and higher voltage than traditional chips. These characteristics allow batteries to last longer, and use less power overall. As a result of car manufacturers scrambling to start producing electric cars at volume, Cree's silicone carbide business is currently growing at c 50% per year, transforming what was a relatively low growth LED lighting company into one with much more exciting prospects. Cree is now the company's sixth largest holding.

No mention of electric cars is worthy without Tesla. Walter has been a long-term investor (and driver), but sold out of the company with the increasingly erratic behaviour of the management. However, now that the share price has come back, he is buying back in once again, with his confidence bolstered by clear messaging from the company that they are focusing on profitability. Whilst it clearly remains a controversial investment that the team themselves heavily debate, in Walter's view the company has at least a five-year head-start on the major car companies – both in technology but also in software and security. With the focus on profitability, and with SUV and Pick-up launches coming soon, Walter believes there are plenty of potential positive catalysts ahead.

Walter and the team retain a flexible and pragmatic approach to stock picking. Tesla is an example, but another is Facebook which the team had completely sold out of when we last reported back in October 2018. However, as the top ten holdings show below, Facebook is now back in favour, the fifth largest holding in the portfolio. Similarly, Amazon has for a while been the largest holding in the portfolio, which this month has been relegated to the bottom of the top ten holdings. The team report that they reduced the trust's weighting in the company because they believe Amazon is expecting to grow expenses faster in 2019, which will likely be a near term headwind for the company's profit growth.

As we demonstrate above, ATT is a very actively managed investment trust, with one of the most experienced technology investment teams in the world at the helm.

Top Ten Holdings As At 28Th Feb 2019

COMPANY	% OF NAV
Alphabet Inc (Class A Shares)	5.2
Paycom Software Inc	3.8
Okta Inc	3.8
Square Inc A	3.6
Facebook Inc	3.5
Cree Inc	3.3
Twilio Inc	3.1
Salesforce.com Inc	3.0
ServiceNow Inc	3.0
Amazon.com Inc	2.8
Subtotal	**35.0**

Source: Allianz Global Investors

They seek to identify areas of 'innovative disruption' and invest in the businesses best placed to exploit it. At any one time, the portfolio comprises between 50 and 70 stocks, currently at the high end of that range at 70. Anecdotally, the team seems to manoeuvre the portfolio around much more than most generalist portfolio managers do over similar time frames. This is perhaps as much a reflection of Walter's high conviction stock picking approach, but also likely the fast pace of change in the technology sector.

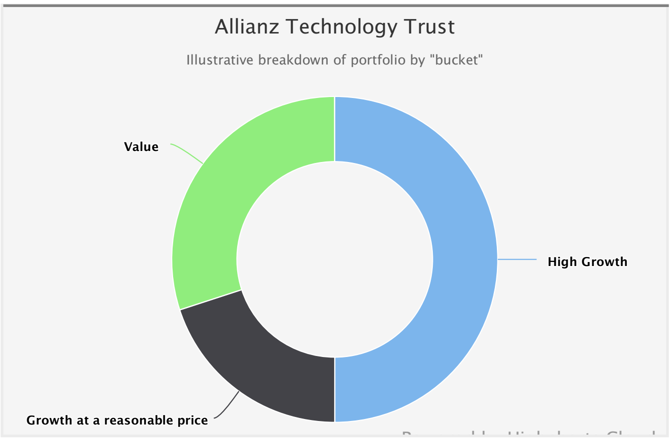
Walter's biggest theme in the portfolio is to cloud and SaaS businesses, which together amount to around 40-50% of the portfolio (including Microsoft, Google and Amazon), but mainly represented by holdings in 15 or 20 cloud software companies. Walter and his team have been paying particular attention to this area, given the transformational effect these companies can have on customers' business models. In Walter's view, 2019 is the best environment we have so far seen for selling cloud software, with many companies set to achieve exceptionally strong sales and earnings growth. The team prefer companies that they describe as "widget-based developers", which offer effective solutions to a wide range of customers around the world. Examples include Okta, which is a leader in identity management, and Twilio which offers customers a communication software module used in "chat" features on websites, or enables 'Internet of Things' (IoT) businesses such as bike rental businesses to use an app to unlock bikes when a customer has paid to rent it.

In contrast to the rest of the portfolio, both of these companies are not profitable. Walter typically prefers to invest in profitable businesses, but such are the exceptional growth rates demonstrated by the companies above, the risks justify the potential rewards in his view.

Looking at the portfolio as a whole, according to Allianz Global Investors' (AllianzGI's) estimates, they have a 3-5 year EPS growth estimate of 32% against 16% for the benchmark. Mindful of valuations, Walter and the team continue to believe that growth will be rewarded by the market.

The team aim to provide a diversified exposure to technology companies, both by "type", but also by style. By this, we mean that the team will rarely focus 100% on pure growth stocks, and will aim to find companies which demonstrate attractive "value" characteristics, as well as "growth at a reasonable price". In the team's view, this approach has helped to insulate shareholders from the worst of periodic market shocks in what is otherwise a relatively volatile asset class.

Fig.2: Illustrative Portfolio Breakdown By 'Bucket'



Source: Allianz Global Investors

Semi-conductors are traditionally part of the "value" bucket, and having sold down exposure during 2018, Walter is building up his holdings here with companies such as Infineon. In his view, such companies will see earnings growth returning in the second half of 2019.

Another significant theme that Walter highlighted when we spoke to him recently was electronic payments. In Walter's view, electronic payments are a highly attractive part of the banking system that is currently being disrupted by newcomers. Companies such as Square and Paypal (which owns Venmo), are expected to benefit from a strong trend in China, with money being increasingly moved through mobile phones. Electronic wallets and other payment companies are expected to take market share as innovation and convenience erode traditional bank services. Walter continues to remain positive on prospects for security businesses, with significant additional investment being required by transitioning to the cloud which necessitates a very different security overlay. Walter continues to own Proofpoint and Palo Alto Networks in this area.

Relative to PCT, the trust is significantly more concentrated (70 vs c.114 stocks as at end January 2019). 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 – especially in the mid-cap space.

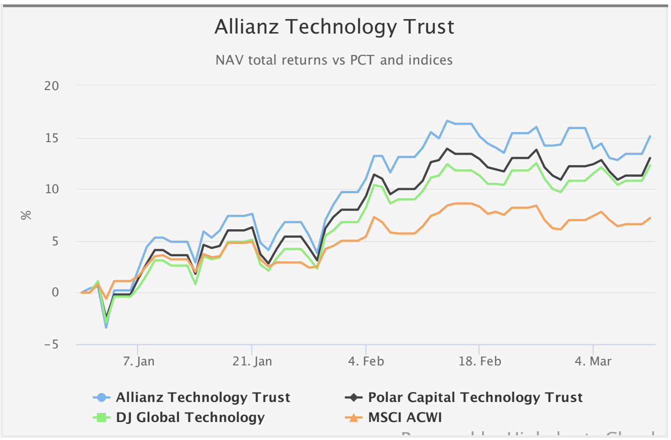
Gearing

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 it 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

As we comment in the portfolio section, performance has been strong this year. The graph below illustrates the strong rebound that the trust has had from the volatility of Q4 2018. At that time, some commentators believed that technology valuations had reached a peak, with a very narrow number of companies having led the charge. As we discuss below, Walter had been increasing the trust's exposure to mid-cap stocks markedly since early 2018, which has meant that ATT has been in a strong position to perform so far in 2019. The graph below shows performance calendar year to date. However, over twelve months to 11th March 2019, ATT is up 12.2%, against the benchmark return (in GBP) of 5.6% according to Morningstar data. ATT has also achieved good outperformance of rival Polar Capital Technology Trust (PCT), which has achieved total NAV return over the same period of 9.4%.

Fig.3: Short-Term Relative Performance

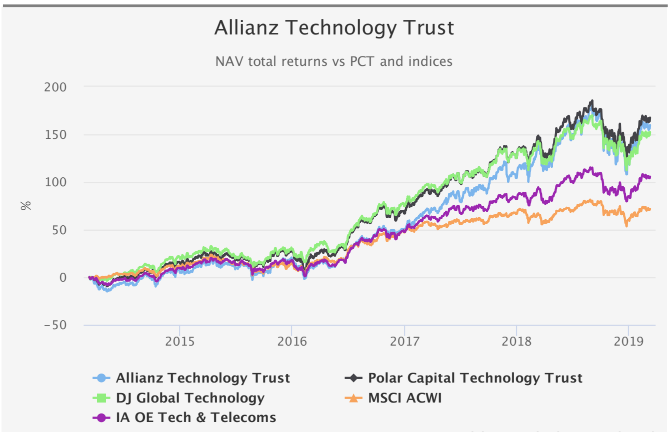


Source: Morningstar

This strong showing over the past year is an extension of a much longer period of outperformance delivered by Walter and his team. They have a long-term track record of investing in the technology sector stretching back several decades. The team took over management of ATT in May 2007, over which time the trust has generated NAV total returns to 11th March 2019 of 549%, outperforming the benchmark by an exceptional 178%. Over the same period, PCT's NAV has achieved returns of 451%, 98% behind ATT but still far ahead of the benchmark.

Over five years to 11th March 2019, the trust has delivered total returns of 160%, ahead of the benchmark return of 152%, but well ahead of the MSCI ACWI's return of 72%. Over this five-year period, the trust is behind PCT thanks largely to the relatively poor performance in 2014 and 2016 when mid-caps (to which ATT was overweight) were out of favour.

Fig.4: Five Year Performance

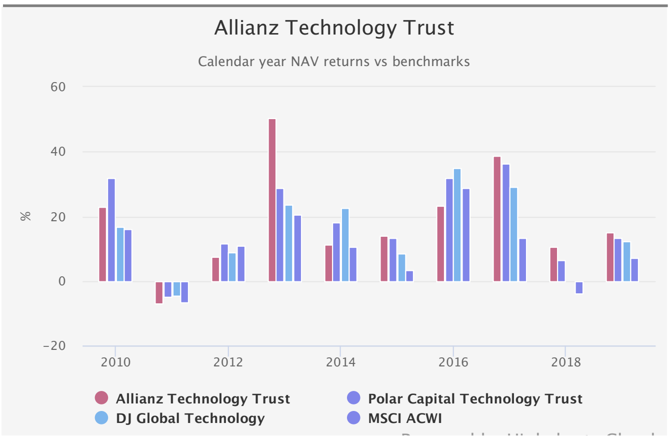


Source: Morningstar

The highly active approach taken by Walter and the team does mean that periods of 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 at the time. As we refer to above, it was this mid-cap exposure that had the opposite effect during 2014 and 2016, causing ATT to underperform. 2017, 2018 and so far in 2019, the managers seem to have hit a solidly purple patch, with strong outperformance in each year, and in very different types of markets.

As we refer to in the portfolio section, 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.

Fig.5: Calendar Year Nav Returns



Source: Morningstar - 2019 data to 13 March 2019

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 live 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, it believes that since the mid-1980s it has 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. It aims to identify major trends ahead of others, investing in stocks that have the potential to become tomorrow's Microsoft, Cisco or Apple. It believes 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.

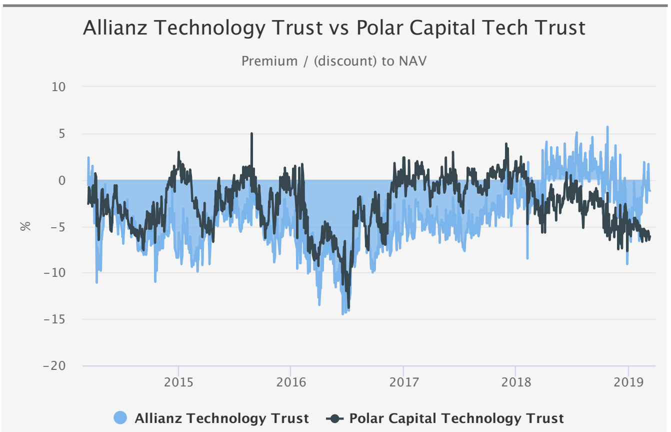
Discount

As the graph below shows, until 2018 ATT 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 reversed since the start of 2018, with ATT trading at a premium to PCT. Over the past year for example the average discount for ATT has been -0.1%, whilst PCT has traded at an average discount of -3.5%.

We would caution that discounts for sector specialist trusts can be 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 issued £95m worth of shares at a slight premium during 2018, and has very recently been issuing shares once again. However, the board does look to try to manage discount volatility on the downside, and 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%. The ultimate long-term DCM is a continuation vote: shareholders 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.

Fig.6: Discount



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, as well as performance fee set relative to the benchmark. At the time of writing the market cap is very slightly above that threshold. According to the 31st January 2019 KID, the company's ongoing costs were 1.02%. The KID RIY costs were 3.61%, with 1.7% attributable to portfolio transaction costs and 0.28% in performance fees.

These performance fees are 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 the NAV is higher than that at which any previous performance fee was paid, but also contingent on performance in that year also being 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.

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