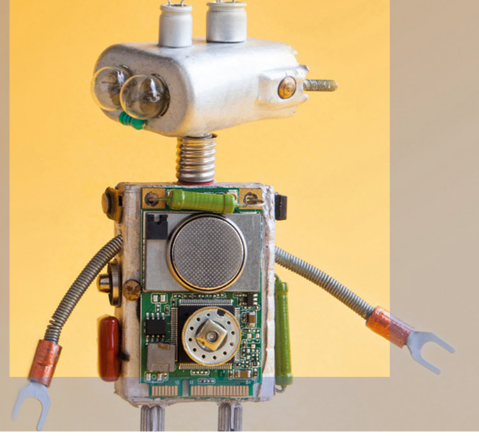

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Investment Insights

www.allianztechnologytrust.com

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Investing involves risk. The value of an investment and the income from it may fall as well as rise and investors may not get back the full amount invested.

Walter Price
Lead Manager
Allianz Technology Trust

With over 40 years of experience of investing in technology companies, Walter Price 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. Based in San Francisco, giving him close proximity to many of the world's most innovative companies, he heads up the Global Technology Team which manages US$4 billion* in assets.

*Source: Allianz Global Investors GmbH.

Investment Insights from Silicon Valley

A year of two parts

Market leadership shifted markedly in the technology sector in 2019. In the first part of the year it was all about higher growth companies; those business growing earnings at 50%+ found favour as interest rates dropped and these cash flows became more valuable. However, valuations started to look stretched and by September, investors had changed their mind.

In contrast, companies such as Microsoft and Apple started the year looking relatively cheap. However, as money flowed into index funds, it benefited those companies that formed a large part of the index – Microsoft and Apple. Apple's share price almost doubled over the year in spite of lacklustre earnings, while Microsoft's share price also saw considerable gains. Today, both are on valuations not seen in 20 years.

In contrast, the higher growth stocks – where the trust has a higher exposure – have been revalued lower in spite of significant earnings growth. Many of these companies have real potential and earnings can keep growing, in our view. The market may become a little more focused on that earnings growth if, as we expect, interest rates start to rise again in 2020.

A changing competitive landscape

There has been considerable merger and acquisition in the technology sector. Whereas once the major companies were siloed and therefore had a captive market, today their businesses are starting to overlap. For example, Salesforce.com has teamed up with Tableau Software, an arch competitor of Microsoft. Increasingly, these companies do not have an open target for future growth but are bumping up against other equally capable and successful companies.

This may mean slower growth; sales people may need to work harder and some of the larger companies are already shedding market share. For some, the conclusion is that they will need to explore new markets. This could take the problem somewhere else. We are already seeing competitive hiring. Google has recently poached senior sales executives from Salesforce to spearhead Google Cloud's sales revamp.

Semiconductor revival

Semi-conductors had a gloomy start to 2019 as investors anticipated the impact of slower global economic growth. We also saw the emergence of semiconductor manufacturing in

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China, which put a strain on the broader semiconductor market.

China currently has a huge fiscal deficit on semiconductors – around $500bn. It makes sense for the government to encourage domestic manufacturing and, as such, it has committed $243 billion[1]. While the projects haven't been universally well-run or productive, they are showing signs of progress in an already competitive global market.

Nevertheless, it hasn't necessarily been able to compete in the specialist markets. There is more specialisation required for semiconductors as cloud storage and big data create greater demand for processing power. The beneficiaries of this trend are semiconductor behemoths Taiwan Semiconductor (TSM) and Samsung, which have the in-house know-how to deal with this new demand. TSM remains our largest semiconductor holding.

Unicorns exposed

Spoiler alert: the problem with unicorns is that they aren't real. For the technology unicorns, it is their profits that have proved illusory. To date, many of these $bn businesses have justified their high valuations in the private equity market by suggesting profitability is just round the corner. The public markets have proved more sceptical.

Many analysts have been suggesting for some time that valuations in the private markets looked ambitious. This was exposed in 2019 as companies such as Uber, Lyft, Zoom and Crowdstrike came to market. Even those companies that have been executing well on their business plans and are sustaining strong growth have seen their share prices perform poorly. For the valuation to make sense, many would have to see 50-100% growth for years into the future. They may do it, but it doesn't leave a lot of room for share price appreciation. To our mind, the price is determined by optimists.

These ambitious valuations create problems for the companies themselves. Many employees hold stock options struck at the IPO price and the allure of a lump sum payout has kept them at the company. If the share price is 30-50% below the IPO price – and yet they are facing taxes on those stock options – they've been working for free. Morale drops and people may ultimately leave for companies where they believe they can make money. In a competitive market for talent, that's a real problem. As such, these companies are under tremendous pressure to raise the share price.

The IPO market has been functioning poorly and valuations remain too high. It may have a painful period of readjustment ahead as the market moves from a focus on revenue growth to profitability.

Good governance

2019 has been the year when shareholders really started paying attention to environmental, social and governance considerations. Technology companies have occasionally been guilty of placing too much emphasis on retaining and rewarding employees, often at the expense of the shareholder.

Some leading technology companies have been trailblazers in terms of governance: Microsoft has been a case study in corporate efficiency; it has also been good at listening to shareholders. For its part, Apple has led the way in terms of privacy.

We would like to see other technology companies follow their lead. There are still controversies over privacy and tax. Certain high profile companies continue to throw shareholder cash at fruitless innovation projects. In 2020, we expect shareholder pressure to sharpen up the focus on governance at many technology companies.

This is no recommendation or solicitation to buy or sell any particular security. A ranking, a rating or an award provides no indicator of future performance and is not constant over time.

Please note that we can only offer information and are unable to provide investment advice. You should contact your financial adviser before making any investment decision.

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1 Source: Bloomberg.com