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Investment Insights from Silicon Valley

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*Source: Allianz Global Investors GmbH.

A second technology bubble?

A recent wobble in some high profile technology stocks has prompted concern over valuations in the technology sector. Are we seeing technology bubble 2:0?

Certainly, the technology sector has moved higher in 2017. Share price growth for Amazon, Apple and Facebook has been 35%, 51% and 32% respectively (source: Thomson Reuters, year to 30 June). At face value, some valuations look ambitious – Amazon at 184x earnings, for example. It is perhaps understandable that investors are nervous.

However, we would argue that valuations are fully supported by equally audacious growth in earnings. Looking at the Allianz Technology Trust portfolio as a whole, earnings growth is around 40%. Earnings across the sector are growing extremely fast and this is being recognised in stock prices.

In the technology bubble of the late 1990s, there were no earnings. Stock market valuations were based on clicks or eyeballs or any variety of unusual valuation metrics. This time technology stocks are rising with earnings. These are high growth companies in a low growth world, and they are rightly prized. If companies are valued at 20-30x earnings with low growth, it would be more of an issue.

In our opinion, the technology environment is better than it has been for a decade. People are spending money, corporate projects are getting funding, and manufacturing equipment is being upgraded. It appears that companies are feeling better about the future than they have been since the recession of 2007. There has been plenty to inhibit people spending money on technology in recent years, but the clouds are clearing.

Big is beautiful?

An easy conclusion from the strength of the largest technology names this year would be that large cap technology is the best way to access the sector. Certainly, in some cases, large caps have an advantage. They are greater beneficiaries of the network effect, for example, that has driven the growth of stocks such as Facebook, one of our largest holdings in the portfolio.

However, there are some fast-growing technology sectors that are only accessible through smaller or mid-cap companies. For example, it is extremely difficult to invest in security through larger capitalisation stocks: The largest company by enterprise value is $15 billion in size (for reference, Amazon, which we hold, is now $462bn). Palo Alto Networks (another of our holdings) is only $11bn. Security is a huge problem for individuals and corporations, and breaches are becoming more frequent. Yet it remains a relatively under-developed area of investment and one that should be subject to stronger growth.

Software-as-a-service is another example. This is the fastest growing secular growth area in technology and yet, with the exception of Salesforce.com, this is also largely confined to mid-cap companies. Equally, some of the automotive semiconductor leaders also tend to be the mid cap companies. These could be among the strongest beneficiaries of the revolution seen in the car industry.

Allianz Global Investors

The importance of corporate culture

The culture at a number of technology firms has come under scrutiny in recent months. Accusations of bullying and sexism have seen high profile leaders replaced. The balance is a difficult one: technology firms are often led by visionaries and while this can help drive a business forward, it comes with certain limitations.

Corporate culture can have an important influence on shareholder returns. Companies that lie to customers or to their investors are generally not good investments. If a company is willing to lie to its customers, all too often they will also be lying to themselves. We are also wary of companies who make bold, political statements in their shareholder presentations. Too often, it is simply spin.

Culture is likely to become more important. Millennials want to work for companies with social purpose, rather than just wanting a job. For skilled millennials, the purpose of a company is very attractive. They want to make the world a better place and want to work for companies with a vision. The best companies, such as two that we hold, Alibaba and Facebook, have a strong purpose and vision that engages their employees. Employees are the lifeblood of technology companies and we believe cultural considerations will become more important in recruiting and retaining talented individuals.

FinTech – the latest developments

FinTech is one of the fastest growing secular growth areas in technology. A recent survey by PwC estimated that the cumulative investment in FinTech globally could exceed $150 billion within five years. As part of the same survey, 75% of respondents said that the most important role of FinTech would be to deliver an increased focus on the customer. We agree with this, and believe that the biggest winners in FinTech will be those companies that solve key problems for their customers.

For example, within our portfolio we hold Square. It helps different types of merchants run their business better - from secure credit card processing to faster access to cash. Rather than simply focusing on selling the card terminal with a fee that's a few basis points lower, they are focusing on what the merchant needs to run their business.

As part of this, they have a free point-of-sale app, which handles invoices and recurring payments, sales reporting and analytics and real-time inventory management. The product suite also gives faster access to cash, and the ability to build a loyalty list. All these innovations allow merchants to grow their business faster and more effectively. In this way, Square is disrupting the old silos. Others are starting to copy them, but are not as good, in our view.

The successful FinTech companies aren't selling a product, they are selling a solution. Winning companies solve problems for customers. They will often bring together various technologies under the surface, but companies just see something that benefits them.

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