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Investment Insights
from **Silicon Valley**

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Walter Price Lead Manager, Allianz Technology Trust

With over 40 years of experience of investing in technology companies, Walter Price has witnessed the technology sector improve user productivity through the revolution in semiconductor design, the birth of the personal computer and the arrival of the internet. 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.

Amazon drones

Amazon's director of UK Operations said recently that all the group's deliveries could one day be made by automated drone. While the concept sounds space-age, the technology is already well-progressed. In fact, the problem is not so much making sure the drones operate correctly, but resolving surrounding issues, such as privacy and theft.

Like many technology investors, we have kept a keen eye on how Amazon is deploying its research and development budget. For many, the use of drones and other radical technical innovation may beg the question as to when technology companies go too far. When does research and development expenditure descend into expensive self-indulgence?

In fact, we are generally minded to trust the innovators no matter how quirky their ideas initially seem. Over the past 300-400 years, they have usually been right. The wackiest ideas have often turned out to be both technically progressive and commercially viable. It is the job of these creative individuals to see what others don't yet see and to understand what people want before they know they want it. History is littered with examples of technical innovation that no-one thought credible, but turned out well. The most recent is perhaps self-driving cars, which are now nearer to reality than the pessimists ever thought possible.

Part of being a technology investor is understanding how a company is deploying its research and development spending, and recognising that all technology companies will spend millions on things that don't work. It's part of being a technology company. More worrying would be companies either not attempting to innovate or making poor acquisitions, whereby companies buy technologies that are not compatible with their strategy.

The risks of supply chains

The reputational risk inherent in the supply chain has been highlighted recently and remains an ongoing concern for technology managers. The majority of technology groups, particularly on the hardware side, outsource to some extent and may do so in countries where there are not Western-style labour standards and governance.

There is an inherent business risk if companies do not know what is going on in their supply chain. This has been seen most recently in Samsung's problems around the use of child labour, but Apple has also had high profile difficulties after unfavourable reports emerged about its suppliers. As well as leaving a distinctly unsavoury taste among investors and consumers, it can also knock the share price quite significantly.

There is no way to check the supply chain in its entirety, and to some extent, we must always take the word of corporate management that their suppliers are properly managed and do not engage in poor practice. Over issues such as child labour, or other serious breaches, it would always be a reason to disinvest. Such poor awareness of the activities of suppliers would destroy faith in corporate management.

However, on smaller breaches, the attitude of management can be instructive. If management reacts in the right way, admits the

*Source: Allianz Global Investors Europe GmbH as at December 2013. This is no recommendation or solicitation to buy or sell any particular security.

problem and takes immediate and honest steps to address it, it can be a sign of their strength. These problems cannot always be avoided, but if management can present a clear plan and show how there will be checks and balances in future, it is not always a reason to sell out.

The old guard marches forth: Microsoft

Microsoft has recently announced the cull of 18,000 employees, or 14% of its total workforce. Not only do these cuts represent the largest downsizing in the company's history, they also mark a significant change of direction by the new management. The job losses are mostly coming from the group's smartphone business, and represent a scaling back of its ambitions after years of losses.

For us, these are not simply another cost-cutting exercise, but recognition on the part of management that times have changed and that it must adjust to the new competitive landscape. The new CEO, Satya Nadella, has shown himself to be receptive to change, willing to challenge all legacy businesses and has specifically stated that there are 'no sacred cows'. In this, he is making a break with the previous management.

We continue to be an investor in Microsoft. We believe that if Nadella continues to move the battleship, cut costs, and find ways to grow revenue in new areas, the company can continue to grow. The shares are still not expensive as the market waits for signs that the changes are effective.

To a lesser extent, this is being seen across a lot of legacy technology companies. Perceptive management teams are trying to find areas that could drive growth. Oracle is trying to make the transition to cloud computing, and companies that have historically struggled, such as HP, are making strides. Some old tech may yet make the transition to new tech.

The private market

As ever, we keep an eye on the private market. Some of the most innovative new technology is created by companies that aren't listed yet and we need to ensure we are analysing the whole of the market. Our network has always included earlier stage companies, although the regulatory rules prevent us from investing. One of the ones we have been looking at recently is Palantir, which is a good example of the type of exciting company that can be found in the private market, for which there is not yet any strong equivalent on the main markets. The company is headquartered in Palo Alto, California and has just undertaken a new round of fund raising.

The company has some innovative software, plus real revenues and a lot of buzz around it. Its clients include governments and major blue chip companies, and it offers solutions in sectors as diverse as pharmaceuticals, defence and cyber security. Its skill is in helping organisations use their data productively. For example, the S.E.C. recently hired the group to help it analyse data to find terrorists and uncover illegal trading activity. When the time comes, we will be in a good position to take advantage of its growth.

Contact Details **Telephone:** 0800 389 4696 **E-mail:** investment-trusts@allianzgi.com

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