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Investment Insights from Silicon Valley

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*Source: Allianz Global Investors GmbH as at September 2015.

Brexit: a perspective

Inevitably, we need to discuss the UK's historic decision to separate from the European Union. The technology sector is unlikely to feel as direct an impact as some other sectors; and while it cannot entirely escape the ramifications from the recent vote, we believe that much of the impact may ultimately be positive.

For example, there will be an impact from the weaker currency. While there are not a lot of listed technology companies in the UK, they do exist and a lower pound will make them more attractive to international buyers. We have already seen this to some extent with the acquisition of Arm Holdings by Japan's Softbank. The depreciation of sterling and appreciation in the yen made the deal far more attractive for the Japanese group. With interest rates low and companies holding high cash balances, we could see more UK companies attracting interest.

This could include companies such as global payments group WorldPay, which we hold. This is an attractive, stable, UK-based business. While domestic growth in the UK may be slower, that is already well-reflected in the valuations of many UK technology companies. Equally, many of these companies may have very little business in the UK itself and therefore may not be particularly exposed to any fallout from Brexit.

We also believe there may well be increased IT spending required to implement Brexit. The separation could be a laborious process, and technology will be an import way of easing the burden.

Revaluing risk

Perhaps most importantly, lower interest rate expectations in the wake of Brexit are likely to see stronger growth companies revalued. For the time being, the uncertain environment prompted by the Brexit vote, among other international issues, such as an imminent US election and fragility in the global economy, has left markets firmly in 'risk-off' mode.

Among technology companies, we have seen valuations of the highest growth stocks moving lower even though most have seen no dent in their short or long term growth prospects. This is understandable: investors are still worried about the outlook and believe the stock market to be over-valued.

However, we believe that as people become more comfortable with the outlook for the economy after 2016, we could see risk re-valued, which could see these companies bounce from their current levels.

In any discounted dividend/earnings model, if interest rate expectations are taken lower, valuations should go up because the risk-free rate is lower. At the moment, the rising risk premium is offsetting that decline, but if risks are considered to have eased, markets may re-evaluate these companies, particularly where growth is driven by market share gains.

For the time being, however, the market is focused on those companies with a strong headline yield and this part of our portfolio is performing well. This includes companies such as Apple, IBM or Qualcomm. Income from treasuries is still at rock-bottom levels and investors are hungry for income.

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This trend is just as marked in the technology sector as it is elsewhere.

Driverless cars

Driverless cars have been hitting the headlines for good and bad reasons. On the one hand, they are edging closer to a reality and promise to revolutionise areas such as long distance lorry travel. On the other, there has just been the first driverless fatality. Although fatalities in driver-led cars do not generally make headlines, driverless cars will be set a higher benchmark and failures like these are significant.

We believe that, in spite of these recent setbacks, the long-term outlook for driverless cars is sound. There are increasingly stringent emissions targets set by regulators. It is difficult to meet these targets with an internal combustion engine car. As a result, we have seen many of the major manufacturers making a concerted push into electric, and then driverless, cars – Volkswagen, for example. Manufacturers are well aware that if they can't find a market in Europe, the Chinese will snap them up.

Also, there is the ease of use argument. On a highway, or in heavy traffic, they are ideally placed. It is so easy to have an accident when traffic is slowing up and slowing down, but driverless cars can keep an automatic two-car distance. On a long drive, drivers get the speed they want and, for the most part, can relax.

We have made good returns from our holding in Nvidia this year. It makes the most advanced autonomous car platform on the market - combining elements such as sensor fusion, and surround vision. In the recent crash, this technology would have detected the hazard and prevented the crash, and is likely to become a vital element of driverless cars. That said, after a strong run in the share price, we have taken our holding a little lower recently. We still have a small weighting in Tesla, which remains at the forefront of this innovation.

Driverless cars are also an important end-market for semi-conductors. They are incorporated into the safety and visualisation systems and will be used to help judge how fast an object is approaching, for example. The manufacturing of driverless cars is also semi-conductor intensive. This is another way the portfolio holds exposure to the sector.

The LinkedIn/Microsoft deal

Microsoft announced its $26.2bn deal for professional social network LinkedIn in June. To our mind, this looks like a good deal for LinkedIn. Microsoft paid the full price. That said, from Microsoft's point of view, it gets an edge in the software-as-a-service business – the number one competitor to salesforce.com. It also helps give it a platform in the social world. Also, Salesforce.com chief executive Marc Benioff has subsequently said that he would have bid higher.

More generally, acquisitions are still happening in the technology sector. Companies want to maintain their growth rates in a low growth world. The cost of capital is low and we would expect to see more deals. While companies are still striving to generate organic growth, there is always a buyer for good assets, particularly those within a company that may not be executing on its business plans very well.

This acquisition hunger gives support to technology valuations across the market. Valuations have moved lower, particularly in some higher growth companies, and that will tempt buyers.

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