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.

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

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Investment Insights from Silicon Valley

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These have been a turbulent few months in markets, and technology has not escaped the rout. In spite of the stabilisation seen in March and April, it has been an unnerving period for investors. However, to our mind, we continue to see new industries being created, while old industries die or are forever altered and technology sits at the heart of this global innovation. As such, the long-term outlook for technology companies remains compelling.

Markets have come a long way in recent years and, as such, some short-term setback was inevitable. Last year saw technology returns concentrated in a number of key stocks, where strong growth rates had, to some extent, generated over-exuberance. As such, some deflation in market expectations has been welcome. However, the fact that the Nasdaq underperformed the S&P over the first three months of the year has reinforced the view of many investors that technology remains a cyclical business, vulnerable to economic conditions. We believe this represents an 'old world' view of technology. In reality, the growth in technology is coming from the creation of new markets, rather than the simply GDP growth. Technology is taking a larger and larger share of economic activity.

This is a low growth world and investors need to find those companies that are generating organic growth through the creation of new markets or by effecting significant change on old ones. Sectors as disparate as cars, security, retail and web services are all being shaped by the pervasive hand of technology. In the process, real value is being created for investors.

Technology currently forms around 20%[1] of the S&P 500 index, its largest sector weight. For the MSCI World, it is just 13.6%[2]. Yet technology forms an increasingly important part of all our lives and there are numerous sectors where technology has wrought enduring, even revolutionary, change.

Advertising, for example, was an industry dominated by TV and print media. Vendors used it to promote a message, but could seldom get a good idea of how effective it was at hitting their target audience. The Internet created a vastly more effective and measurable way to target consumers, allowing vendors to be precise in ensuring their message reaches the right audience. Digital is now around half of advertising revenues, compared to just 10% as little as 10 years ago. This trend now has real momentum and the next target area is likely to be television advertising. Technology-related companies may soon make up around 75% of the advertising market. This is a profound change and equates to hundreds of billions of dollars.

A similarly profound change may be seen in the car market. At the moment technology only captures around 5% of the car market, mostly in areas such as semiconductors. But worldwide attention on global warming and CO2 emissions promises to effect significant change. Transport is a target area for policymakers, and emissions rules are steadily tightening. The move to electric cars is building momentum. Tesla has built an electric car that people want to drive and has already started to disrupt the market, taking around 25% of the higher end car market. From here, Tesla may lead, or it might be a Chinese car company, but a whole new

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industry is up for grabs. Equally, we have the rise of the connected car. Cars will need certain characteristics in order to be successful in future. The next generation of transport may come from Google; Uber will be part of it. This is little short of a revolution and potentially creates significant value for the companies involved.

We would also highlight the move of enterprises to the cloud. Companies used to have their own internal computer centre and typically 20% of the IT budget for companies might go on hardware and software. This was inflexible and did not allow companies to manage IT spending in line with the business cycle. It also meant that technology spend was cyclical, geared to those times when companies had cash to spend. The emergence of cloud computing has changed that. Instead of companies managing technology in-house, companies are now outsourcing their storage requirements, allowing them to manage their costs more flexibly. The revenue available to vendors is likely to increase exponentially in the future as enterprises outsource.

For evidence of the profound change technology can effect on certain sectors, investors only have to look at retail. Incumbents have fallen by the wayside, as companies such as Amazon in the US, or Alibaba in China have become dominant. While 10% of retail is currently done online, it is easy to see it become 50% within a relatively short time frame. This has an impact for almost every retailer, with many having to change the way they operate, with fewer stores and a compelling online presence. These changes create great value for investors as they are happening. The result is that technology is growing as a percentage of the overall market and technology vendors are capturing a greater share of business and consumer spending.

Technology is no longer a purely 'growth' sector, no matter how much the market would like to treat it as such. Certainly, the sector retains many businesses growing rapidly: Amazon and Facebook, for example, are still seeing revenue growth of around 50% per year. However, the sector has alternative options: Microsoft and Apple, for example, could be considered more 'value' companies. IBM or Intel are looking to transition to the cloud and would sit as more 'value' or 'yield' companies. In other words, we have a mix of all types of company in the sector, which means the portfolio can perform in a range of market environments. The diversity of technology companies has been over-looked in the recent market volatility.

After the rout, valuations in public markets are now more realistic, with any irrationality largely confined to 'unicorn' valuations in the pre-IPO and private equity markets. We would also argue that this recent sell-off allows investors to tap into the long-term growth of technology at far lower valuations. Nevertheless, we still believe technology is a sector that rewards judicious active management. Last year, the technology sector performed well, but performance could be attributed to a relatively narrow handful of stocks. We are optimistic that this can broaden out, with lots of companies executing well on their business plans, delivering as promised. We hope that the recent volatility ushers forth a more thoughtful era, where markets are more inclined to look at fundamentals. It has also brought valuations lower and, as such, represents a real opportunity.

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[1] http://us.spindices.com/indices/equity/sp-500

[2] https://www.msci.com/resources/factsheets/index_fact_sheet/msci-world-index.pdf

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