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# Investment Insights
from **Silicon Valley**

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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.

## Semiconductor sell-off: a time to panic?

**There has been a notable sell-off among semi-conductor stocks this month, enough to drag the Nasdaq lower and raise fears of a wider slow-down in the technology sector. The catalyst for the share price falls was a profit warning from Microchip Technology, which cited weaker demand in China. At a market capitalisation of $8bn, Microchip is far from a sector heavyweight, but it has historically been seen as a bellwether stock for semiconductor demand.**

For example, in 2008, Microchip made a similar announcement and it was the start of a wider correction for the sector. Equally, when the stock saw improvements in 2011, it marked the beginning of a turnaround. The market has extrapolated weakness and this has pulled down the whole semiconductor sector, including Intel, where the share price was down 8% in a single week. The news is perhaps more worrying because September is often peak season for infrastructure demand.

The other concern is that the fortunes of the semiconductor industry can be a leading indicator for the rest of the technology sector. After all, semiconductors are a key component of technology equipment across the globe, from smart phones to televisions.

This is clearly a concern, but for the time being we believe that the market is extrapolating too much from just one piece of weak data. However, it is right to question whether this is an inventory correction or the beginning of a recession. Still, until we see more compelling data for the latter, we believe this could be more of a Microchip-specific issue and less of a sign of broader weakness to come.

## Technology's USP

At trickier times, it is perhaps worth a reminder on why technology investment makes sense. The long-term secular story for technology remains, in our view, sound. Technology as a percentage of the market has been moving higher consistently for two decades. Equally, technology is becoming a more important factor in more industries. For example, ten years ago a car supplier would not have been considered a technology company, but now, with the connected car, the driverless car, and internet entertainment and navigation systems, with real-time traffic, technology plays an increasingly important role in the driving experience and the successful application of technology is key to that experience.

Innovation such as cloud computing also shows how new, huge markets can build up within the technology sector. Cloud computing is on track to be a $500bn business. These companies are taking infrastructure investment - which may be as much as 10x the software/hardware investment - and converting that into software-as-a-service: The benefit to the customer is that they typically spend less money to install and maintain the product and they get a more flexible, pay-per-usage solution. The benefit to the vendor is that they get a more predictable stream of revenues.

The development of new markets typically leads to higher secular growth in the technology sector compared to the broader economy. As such, we believe technology should be part of a growth investor's portfolio.

Technology positioning and leadership is volatile and therefore, a dedicated manager makes sense. Even as great an investor as

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

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Warren Buffet has chosen only IBM to invest in, and that has not worked out well recently. Amid the volatility, it can be difficult to remember that the sector has secular, as well as cyclical, growth.

## M&A in technology

As the global economy has improved and confidence has increased, merger and acquisition activity has re-emerged as a potent force in markets. The technology sector has been at the forefront of this, with deals between IBM and Lenovo, for example, or SAP and Concur.

Technology is a sector that naturally lends itself to merger and acquisition activity: First, there are a number of large, cash-rich companies that need to transition their businesses to the Cloud. This is difficult to do organically without compromising their existing business: they must endure a lot of front-end losses, while building up their cloud capabilities. They might need to burn cash for several years, with all the negative implications for their earnings positions. Unsurprisingly, many have concluded that it is easier to buy a company that has already gone through that transition.

It's a strategy that can work. Though we don't own it, we think SAP has established a smart strategy of surrounding its core software with cloud-based products that interface with their core software. Eventually it could get enough traction from the cloud products to turn its core solutions into a cloud product. If it had tried to do this in one go, it would have seen a precipitous drop in revenue. This would be a disaster for the share price, so it has to work out an alternative path.

Piecing together a business in this way is not as elegant as the solutions built by ServiceNow, Workday, or Salesforce.com – all holdings in our portfolio. Here, the software has been built from scratch in the cloud and all works together.

The other type of buyer is a financial buyer. Financial buyers typically come in, introduce debt and reduce costs. Again, this has its advantages and disadvantages, but overall, M&A activity is likely to continue to provide support for parts of the technology sector.

## Apple's barnstorming fourth quarter

Apple issued storming fourth-quarter results, trouncing Wall Street forecasts on revenue, earnings and iPhone sales. Revenue topped $42bn in the quarter, up 12% and its strongest growth in almost two years.

Debate remains as to whether this is simply a strong replacement cycle and that Apple is still, technically 'ex-growth', or whether Apple is a growth company that continues to attract new customers. If it is just a replacement cycle, then it's an extremely strong one. The iPhone 6 has proved to be a great product and the plus-sized version is a particular hit with the all-important Chinese market.

Nevertheless, Apple still presents a thorny problem for technology managers. While it is our largest holding at around 7%, the benchmark weighting is more than 13%. It is therefore difficult to take a positive relative position in the stock. We have covered a portion of this gap by holding shares in companies that make components for Apple's iPhones. Another note of caution for us would be the amount of broker 'buy' ratings on the stock. Apple is one of the most popular 'long' holdings in the market, and it is rare to find a broker with a sell recommendation. History suggests that this should encourage caution.



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