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Investment Insights from Silicon Valley

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

Technology builds new markets

One of the key differentiating factors of technology – and why it is such an exciting place to invest – is that it has the power to create new markets. Certainly, this may happen sporadically in retailing, or construction, or oil and gas, but permanent, ongoing disruption is a characteristic unique to technology.

Some of these stories are well-understood and have largely been reflected in valuations. For example, we believe the move to mobile and online retailing is recognised by investors (though in some cases, the pace of growth may have been underestimated).

But technology is creating new markets all the time. As new industries emerge, there is often significant value up for grabs. It is not always clear early on who will be the winner from significant technological change; there may be several winners and early adopters may not always triumph.

We are currently making these judgements about the emerging security sector. This is clearly set to be a powerful sector. Barely a week goes by without a major organisation experiencing some kind of data breach, with all the associated threats to their business. This is the price of living in a connected world.

While the market could be $14-15bn in size, getting access to it hasn't proved easy. There are no major dominant players: For Cisco, for example, security only represents around 10% of its business. This is an area where medium-sized companies may prove very important. Equally, it is unlikely to be an area where the 'winner will take all': there are several companies that could grow rapidly. We currently favour Palo Alto Networks and Salesforce.com and there's room for other cloud-based software companies in this area.

This is happening across myriad sectors – cloud computing is changing the landscape for enterprise computing, mobile retailing for advertising, plus innovation such as the connected car.

A reminder in difficult times

This should be a reminder of the importance of technology's place in a portfolio. Investors would be forgiven for wavering after a difficult start to the year in markets, but markets are still prone to treating technology as a cyclical sector. The reality is different; far from depending on growth in the wider economy, technology is one of the few sectors grabbing a greater share of the global economy with technology vendors capturing more business and consumer spending.

As we see it, the technology sector offers many different types of opportunity: While Amazon and Facebook, for example, might fit the traditional view of a 'growth' stock, Microsoft and Apple could be considered more 'value' companies. For all these companies, the drivers of growth extend far wider than simply the economic environment – the move to the cloud for Microsoft, the upgrade cycle for Apple. Plenty of technology companies now pay healthy dividends, The diversity of technology companies has been over-looked in the recent market volatility.

Allianz Global Investors

Executive pay – the right incentives

Executive pay has become a significant issue across the globe. Goldman Sachs and Deutsche Bank have been forced to face down shareholder revolts over executive pay and corporate excess. BP's chief executive has also come under fire for his pay packet. This is an important issue for shareholders and fund managers alike.

In an ideal world, chief executives in Silicon Valley would have around half their compensation tied up in the stock. However, there are problems with this. As technology companies attracted higher valuations, stock options were less appealing. It was difficult to attract talented employees when the stock options weren't likely to be worth much unless the company created vast new value. As a result, there has been a trend towards Restricted Stock Units (RSUs) in more recent years.

The problem with all stock-based compensation is that employees will leave if the shares are doing badly, which can be self-reinforcing. Also, some chief executives have taken this to extremes, which has proved dilutive for shareholders. Nevertheless, we still like to see a significant portion of manager pay tied up in a company's stock. There should be a balance between giving money to shareholders, to existing management and to new management.

In general, share-based compensation on the whole is what drives executives to work as hard as they do. If executives have success in building a company, they should get a big pay day. As long as long-term considerations are not set aside in pursuit of short-term share price appreciation, it works well as an incentive.

Samsung issues a challenge

It has been a buoyant quarter for Samsung. The world's largest mobile phone maker by volume reported higher-than-expected first-quarter earnings on the back of a good reception for its new Galaxy S7 and Galaxy S7 phones.

This marks a significant turning point for the company, which has seen a two-year decline in its mobile business, progressively losing market share and seeing its profits slide as a result. Could it now finally start to challenge Apple, and low-cost Chinese rivals such as Huawei?

This is undoubtedly good news for Samsung, which is slowly stabilising and gaining back market share. However, it has a lot of lost ground to regain. It has lost out to less expensive vendors in emerging markets. It has been forced to re-engineer its products at a more cost-effective level and this is the first sign that its strategy is working.

However, we are still sceptical about Samsung's ability to beat some of its rivals in the longer term. We have greater respect for Apple and Huawei. Huawei, for example, spends around half its resources on research and development. It's an engineering-led company, growing 50-100% per year. It is difficult to see how Samsung is going to compete in the long-term.

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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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