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Investment Insights from Silicon Valley

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*Source: Allianz Global Investors GmbH as at Nov 2014. This is no recommendation or solicitation to buy or sell any particular security.

Wobbling bond markets and the 'bond proxy' phenomenon

A June rise in interest rates now looks increasingly unlikely, with some commentators believing the Federal Reserve may defer into 2016. Nevertheless, bond markets are wobbling and the issue of interest rate rises continues to influence stock markets. The technology sector is not immune.

To date, the prospect of rate rises has been felt most strongly in the 'high growth' part of our portfolio. This sold off last year as investors started to reassess valuations in the light of potentially higher rates. These have recovered as the speed of interest rate rises has been revised lower. Investors now recognise that interest rates are unlikely to go from 0.5% to 4-5% in short order, but any rises will be gradual and based on the prevailing economic data.

We have stayed with many of these companies, which may be as much as 50% cheaper than at the end of 2013 and are still growing at 50-100% per year. Some are nearing profitability and this should offset any rise in interest rates. A bigger issue may be whether the growth rate in the economy is in tact.

Equally, the issue of 'bond proxies' continues to exercise investors. This is a global phenomenon: The decline in bond yields has brought investors reluctantly to equity markets. Those investors have focused on the largest, most stable companies, pushing valuations to uncomfortable levels. The fear is that as the economy improves and interest rates rise, safety will not be as highly prized and these stocks will sell off.

Those technology companies that could be considered bond proxies – Microsoft, Apple, Oracle, IBM, for example – are some of the cheapest companies around. They are trading at historically low levels relative to the wider market. The surprise, perhaps, is that in a climate where predictability of earnings is valued, these companies do not command a higher price. Admittedly, some need to demonstrate that they can make the transition to cloud computing, but even with this caveat, these companies are unusually neglected.

Social media goes quiet

Social media companies have been uncharacteristically quiet this year, with no high profile IPOs or product developments to grab headlines. This should perhaps tell investors something about the state of the social media industry. While we still have holdings in Facebook, Google and LinkedIn, our overall weighting in the sector is considerably lower than it has been historically and around half that of our benchmark.

These are undoubtedly good companies, but the sector is maturing, putting its ability to grow at 50% or more from here in doubt. Notably, advertising budgets are only rising 3% per year. The Internet is around 40-50% of that budget, so there is simply not a lot left to take. As a result, these companies are moving to a lower growth rate, but market expectations have not yet adjusted fully. We are becoming increasingly cautious on the likely growth rate for these companies.

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Some companies are notably worse than others: Yahoo hasn't grown in two years, while Tencent in China is addressing the problem by moving into transactions and ecommerce. People will be able to use Tencent to call taxis via Uber, or buy food through GrubHub with Tencent getting a slice of every transaction. However, success is not inevitable, as Facebook and Google have found out.

Shifting security budgets

A recent trip to the RSA Security show confirmed our view that security is a hot topic for corporates and investors alike. Attendance was up 50% over last year and the event was crowded with corporate buyers with apparently big budgets. It had been thought that the appreciation of the dollar might hit spending patterns, but we saw no reluctance on the part of buyers.

One of the banks did a presentation at the event, which to us neatly illustrated the shift in security spending. Previously, the bank had spent 80% of its budget on prevention – firewalls and anti-virus software. Now only 40% of the (increased) budget was being spent on prevention, with 40% on detection, 15% on analysis and 5% on response.

For us, the increase in the analysis budget was particularly important following our recent purchase of Qualys. A favourite trick of hackers is to exploit a known security breach while it is being fixed. Problems take time to be resolved and this creates a window of opportunity. The Qualys system aims to stop that happening – it looks across a company's servers and analyses the state of its software to detect vulnerabilities and addresses them. It provides a 'patch' until the problem can be dealt with fully.

The Internet of Things

The prospect of an IPO for fitness tracker maker 'Fitbit' has focused attention on the development of the 'Internet of Things'. In this context, 'things' are a network of physical objects that busily collect data and deposit it automatically on the Internet, where it can be analysed and used. Fitness trackers – wrist-worn devices that monitor health data such as paces walked, heart rate or sleep – have become the most obvious manifestation of this. When Fitbit filed its prospectus for an IPO of around $100m last week, it surprised markets with the strength of its revenue generation.

However, the Internet of Things is about far more than monitoring health data. These types of tracker devices can be used for environmental monitoring, infrastructure management, and have even been heralded as the saviour of the bee population. https://www.yahoo.com/tech/how-the-internet-of-things-could-save-the-bees-117114866924.html. Technology research group Gartner estimates that there will be nearly 26 billion devices on the Internet of Things by 2020.

This is clearly an important phenomenon, and as investors, we need to decide how to participate. Some of the more obvious routes have been widely discovered. For the time being, we have chosen to reflect the Internet of Things in our portfolios through investment in the semi-conductor industry. We have Arm Holdings, for example. We will wait and see what else comes to market and at what price.

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