



# Volatility in Technology Highlights Importance of Selectivity

We believe the sector's long-term growth stories remain strong.

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## KEY INSIGHTS

- The recent pullback in technology stocks appears to be due to profit taking after a strong run pushed up valuations.
- We believe that long-term, secular growth trends creating value in the technology sector remain intact and have accelerated during the pandemic.
- The potential for further volatility could favor stock pickers with deep knowledge of individual tech companies and business models.



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The recent pullback in technology stocks strikes us as a normal bout of profit taking after the sector's strong run. Although the broad-based sell-off can be unsettling for investors, we believe that the powerful secular trends underpinning the technology sector's most appealing long-term growth stories remain intact. The digitalization of the economy has shown signs of accelerating, from growing adoption of e-commerce, online advertising, streaming media, and cloud-based software to the proliferation of semiconductors in the automotive and other industrial end markets.

## Strong Performance Invites Profit Taking

Over the eight months ended August 31, 2020, information technology (IT) had outperformed the S&P 500 and the index's 10 other sectors by a meaningful margin. The companies with the five largest weightings in the S&P 500 at the end of August—Apple, Microsoft,

Amazon.com, Facebook, and Alphabet (Google's parent company)—also fared well, accounting for more than 800 basis points of the index's return over this period.

For many tech stocks with well-understood growth stories, valuation multiples based on trailing financial results or consensus estimates for the next 12 months reached levels that looked increasingly demanding. On this basis, rapidly growing enterprise software companies appeared to face especially high expectations.

Worries about valuations and the economic uncertainty stemming from the coronavirus pandemic and the upcoming U.S. presidential election meant that investors often wondered how much higher prominent technology stocks could go as they climbed the proverbial wall of worry.

Huge, single-day upswings in shares of individual stocks likewise contributed to fears of a potential bubble in the

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tech sector and broader market. In some instances, these price moves came in response to robust quarterly earnings that surprised to the upside by a wide margin, reflecting stale earnings estimates from sell-side analysts and a dynamic environment where the coronavirus pandemic has helped to accelerate adoption of some technologies. At the same time, big moves in some popular stocks appeared to be catalyzed by questionable reasons, such as stock splits, that have little bearing on the prospects of a company's underlying business.

Now, investors are questioning the stability of these gains and how far technology stocks could fall before finding a foothold.

#### **Focusing on Fundamentals**

We understand concerns about the near-term outlook for tech stocks. However, we focus on the secular trends that we believe can create value over the long term. Especially during periods of volatility, we believe that our deep knowledge of individual companies and business models can give us an edge in identifying and striving to take advantage of appealing opportunities.

The market's recent excesses do not compare to the dot-com boom and bust of 20 years ago, when highflying tech stocks offered more flash than substance, in our view. The technology-driven changes taking place throughout the economy are widely acknowledged, even if there is debate about their durability and magnitude.

Today, the dominant online social media, e-commerce, and cloud services platforms have proved the durability of their businesses. The same goes for the software-as-a-service (SaaS) model, where customers benefit from increased flexibility and lower IT infrastructure and support costs, thanks to cloud-based delivery of these solutions. Meanwhile, the SaaS providers themselves have enjoyed steadier cash flows compared with the pattern of feast and famine that

came with selling packaged software under perpetual licenses.

The coronavirus pandemic has accelerated adoption of e-commerce, both in established categories and in large markets, such as food and beverages, that had been underpenetrated—a shift in consumer behavior that we believe has staying power in the U.S. and international markets. This strength has filtered through to the targeted advertising provided by large social media companies; in our view, the resilient demand among direct-response advertisers suggests that these online platforms could capture a greater share of marketing budgets during the recovery.

Over the longer term, we see the potential for enterprises to accelerate their transition to the cloud as they seek to improve business continuity, unlock efficiencies, and enhance their competitiveness. We view the semiconductor industry as another area of longer-term opportunity, as the digitalization of the economy should drive increasing demand for advanced chips in data centers, artificial intelligence, automobiles, and industrial end markets.

#### **The Case for Active Management in the Technology Sector**

An actively managed portfolio is not a panacea against volatility in technology stocks, but we believe that our global research capabilities can give us a leg up in identifying stocks with potentially compelling risk/reward profiles and taking advantage of near-term dislocations in the market.

In the software industry, for example, short-term valuations have tended toward the high side in recent years, reflecting the appeal of the SaaS business model and the potential for compelling growth as innovative companies take share from legacy providers and benefit as enterprises embrace the cloud.

We are cognizant that elevated valuations reflect high expectations and can exaggerate moves to the downside when the company in question reports an earnings hiccup or short-term regime shifts favor cyclical industries over secular growers.

But not all software companies are created equal, even if they trade at the same enterprise value (equity plus

debt) to sales and have been growing their revenue at a similar rate. In these instances, we believe our bottom-up approach and deep knowledge of individual business models and industry dynamics can provide us with an edge in identifying instances where the market might not appreciate the durability of its core business, the potential for second and third acts to enhance its growth story, or its prospects for margin expansion.



### **WHAT WE'RE WATCHING NEXT**

The coronavirus pandemic has pulled forward significant demand in areas such as e-commerce and cloud-based software, raising questions about the sustainability of these trends and the risk that this near-term tailwind creates a high bar of expectations for next year. We constantly reevaluate the durability of our holdings' and potential investments' growth stories as we seek to lean into areas where our differentiated views give us conviction while avoiding impostors whose growth prospects may not prove as durable.

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