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Global Technology.

TECHNOLOGY REVISITS A MILESTONE BUT WITH A BRIGHTER OUTLOOK NOW.

EXECUTIVE SUMMARY

For the first time since the peak of the dot-com bubble 15 years ago, the Nasdaq Composite Index reached the 5,000 level in early March. But the underpinnings for the technology sector today are much firmer than they were back then. And a wave of innovation across the globe—including the growth of the Internet, widespread adoption of smartphones and tablets, cloud computing, and innovation in automation and robotics—projects a much brighter future, offering long-term investors significant opportunities to capitalize on such trends.

Josh Spencer, portfolio manager of the Global Technology Equity Strategy, discusses some of the dynamic developments and global opportunities across the technology sector.

REVISITING THE 2000 TECH BUBBLE: THEN AND NOW

Q: The technology sector has experienced tremendous progress and fundamental changes since those frenzied days at the peak of the dot-com era 15 years ago. It has staged a strong recovery from the global financial crisis and was a leading market sector over the past year. What have been the main catalysts propelling tech performance in recent years?

A: Well, it's interesting if you think back to the tech bubble, and then coming off that period in the early part of the last decade, tech companies actually spent all the way up until about the 2005–2006 time frame really licking their wounds.

And during that time, they were cutting costs, improving their balance sheets, and getting out of non-core businesses. So going into the Great Recession, they had already taken some of the cost actions that other companies needed to take.

So tech companies came through that period a lot stronger. It's almost as if they matured before our eyes over that decade, and then coming out of the Great Recession, tech companies were well positioned to outperform. What we've seen is margin expansion and improving revenue growth, and, importantly, dividends and stock buybacks are no longer a bad word in tech. So this maturation of the industry has really played out, and it's helped stock performance.

Q: Certainly, given that progress, it's a far different sector today compared with that era of Internet-driven mania 15 years ago when many tech companies had little or no earnings but were afforded ridiculous valuations. So when you think about the quality of management, the quality of the business model, and the pace of innovation—are they all much better today than they were then?

A: Oh, much, much better. It's as if we've been through a trial by fire over the past decade, and the companies that have come out on the other side are healthier and much better managed with better cash flows, and the valuations in the tech industry are based on real factors like earnings and cash flow as opposed to eyeballs or clicks.

Amazon, oddly enough, is a company that's crossed the chasm and was part of both worlds. If you look at their position today compared with 15 years ago, you see dramatic improvement.

Amazon today is on the verge of threatening major companies like Walmart and Target in their retail business and companies like IBM or Hewlett Packard in their cloud computing business. If you go back 15 years ago, this was an upstart online book seller.

Some of the other leading companies like Apple have begun paying dividends and buying back stock. Even companies that haven't yet started doing that, such as Google or Priceline, certainly have the capacity to generate cash and buy back shares.

I actually think, in the coming years, tech will be an area of cash return and cash generation and the source of future dividend growth.

DYNAMIC TRENDS

Q: There are so many exciting, transforming technologies today that provide a wealth of investment opportunity, including global adoption of smartphones and tablets, social networking, the explosion of digital data, cloud computing, and innovation in automation and robotics.

Which trends are really enduring investment themes, and how do you take advantage of such opportunities?

A: Well, everything you mentioned is a real theme that we've thought about. They're all in different stages of their evolution and also present different investment opportunities.

The ones that I'm most interested in are what I would call continuation of the offline to online trend, and that really is the growth of the Internet companies. And I would point to broader-based Internet platforms, both in the U.S. and abroad—companies like Google, Amazon, Alibaba in China, and Tencent in the Asian markets as well as more vertically focused companies that work in specific end markets.

So think LinkedIn in recruiting, Zillow in real estate, Netflix in video. Those companies really are attacking large markets. This trend from offline to online is only going to accelerate in coming years.

Another important theme is in the software sector, and there I see some early-stage small to mid-size companies that are really disrupting large incumbents. Companies such as Workday, Salesforce.com, NetSuite, and ServiceNow are actually delivering their software over the Internet on a subscription basis.

That compares with companies like Oracle or SAP that have their software installed on large mainframes in a company. Workday or ServiceNow allow a simpler model and easier upgrade path, and companies like the subscription as opposed to paying a big one-time fee to a company like Oracle. So I think there's a lot of room for disruption there.

In the automation and the industrial economy, we're seeing technology making its way into end markets that we don't necessarily think of as being tech markets—the amount of automation equipment that's going into factories and robotics making their way into the home and onto the shop floor.

There are companies that we've studied in the Asian markets like FANUC in Japan and HIWIN in Taiwan. I don't own either one today due to valuation reasons, but they're really taking labor out of the factory shop floor.

And that saves on costs, but it also has led to increased productivity and tighter tolerances in manufacturing. These robots can frankly accomplish a lot more than we would have dreamed of five or 10 years ago. A lot of things that we thought were science fiction when I was growing up are actually reality today.

It's a different world. It opens up opportunities in things like medical, defense, and aerospace, and the beautiful thing about these end markets is that they tend to be richer with profitability opportunities, so the tech companies aren't necessarily engaged in a cut-throat race to the bottom. They're actually adding features and functionality that are highly valued and important to their customers.

Q: I guess the auto industry, at this point, remains the largest end market for factory automation?

A: Yes, I've toured the factory floor at Tesla's facility, for example, and what they're doing with robotics and automating that process is just incredible. To think that a company that size could compete with industry giants like GM and Ford and BMW is a testament to what they've been able to accomplish with electronics and automation.

When you think about electronics going into the automotive market and a new car today, the features that define it are much more electronic, both in terms of infotainment and safety, more so than things we thought about, say, 10 or 20 years ago like horsepower and size of engine.

THE PACE OF INNOVATION

Q: Would you say the pace of innovation today is much greater than it was even just a few years ago?

A: Well, probably everyone thinks the pace of innovation is always faster than it was a few years ago.

To me it seems incredibly fast. And just over the past five or 10 years, looking at the growth of these companies such as Tesla, who would have imagined fully electric cars competing not just on subsidies, but really on performance and quality? Even five years ago, it probably would have seemed unheard of.

And look at the Internet sector and what's happening with respect to communications, the growth of messaging apps, and being able to transmit data and communicate with people around the world in real time. That's something that obviously was unheard of 10 or 15 years ago. It's really just growing by leaps and bounds.

I think a really interesting frontier for innovation is now in the enterprise. Mainstream enterprises, both in the U.S. and around the world, have been actually a little bit slower to change.

Consumers have led the charge in terms of innovation and being accepting of new models. Consumers have driven the Internet and companies like Google and Facebook, but now the enterprise is starting to adopt consumer-grade technology. So we see it with communication platforms or software delivery models. I think the enterprise is really the next area that's ripe for disruption.

INNOVATION IN THE U.S. AND ABROAD

Q: When you evaluate technology opportunities and innovation across the global landscape, how do you compare those in the United States with developments that you're seeing in overseas markets? Is the U.S. still considered the leader in tech innovation?

A: There are centers of excellence for technology around the world. Certain industries like software and the Internet still tend to be largely focused in the U.S., and so you see a concentration in Silicon Valley of companies like Google or Facebook or Amazon in Seattle.

But then if you go to the UK, they've got a fantastic culture of innovation in things like semiconductors. ARM Holdings is based there. The world's largest and best manufacturer of semiconductor equipment is actually based in the Netherlands.

We talked about Japan and the presence of robotics there. China and India have developed their own indigenous Internet cultures, partly because of regulation and partly because they've had a culture of innovation lurking beneath the surface.

So I'm really looking around the world on a stock-by-stock, company-by-company, and country-by-country basis and trying to find the best opportunities. At the moment, I'd love to find more opportunities outside the U.S. The U.S. stock performance has been much better than the rest of the world over the past 12 to 18 months.

But as you can probably imagine this deep in a stock recovery cycle and with what we're looking for on a multiyear basis, we have to apply a very high filter. So it's hard to find very good ideas.

A REVIEW OF GLOBAL TECH STRATEGY

Optimism on Amazon.com

Q: As of June 30, Amazon.com was one of the largest holdings in the strategy. The stock performed very well in the first half of this year, but it had a steep fall, about 22% actually, last year as investor skepticism increased over the company's profitability prospects. But you're still optimistic on Amazon's future?

A: I couldn't feel better about it. Of all the companies and trends that we've talked about, Amazon is one of the few that crosses a number of different areas. It's the leader in e-commerce here in the U.S., and also in Western Europe and Japan, and it's making investments in India and China.

But they're also the leader in cloud computing, and they provide the infrastructure for companies that want to outsource their IT. Amazon started building this business because they learned so much about tech and got so good at running their own infrastructure that they felt they should offer this expertise to other companies.

You may recall the anecdote that Amazon actually won the contract to supply IT to the CIA over IBM. Of course, people know the adage: No one ever got fired for choosing IBM. But in this case, Amazon beat them not only on price, but also on quality.

When IBM protested that award, the CIA said it wasn't about price, it was about quality, and we just don't think you can provide what Amazon provides. That's fantastic. You couldn't ask for better marketing than that.

As you mentioned, Amazon fell 22% last year. It's rebounded about 40% in the first half of this year, but I think there's a lot more to come. Amazon has been investing very heavily in this cloud computing effort, and in my experience, investors go through periods of belief and disbelief about Amazon's investments.

We've been through a period of disbelief, but I think there's plenty of evidence that Amazon is making healthy and productive investments, and when they come out of this investment cycle, I think they'll do so with accelerating revenue growth and that the stock will reflect that.

PESSIMISM ON APPLE

Q: Well, it seems you have a contrasting view on Apple, the world's largest company in terms of market capitalization and one of several industry leaders that reported better-than-expected earnings as the rollout of its iPhone 6 exceeded forecasts.

Apple is reasserting its dominance in the mobile phone market, its stock was up 41% last year, and yet, you eliminated the company from the strategy saying, "Hardware-based firms such as Apple have less of a future as the locus of innovation moves to software and media firms."

Can you elaborate on that and why you decided to eliminate Apple?

A: Yes, I think that's true. I do think hardware-based firms will struggle more in the coming years, and I think history has borne that out. When you think about leadership of the mobile phone industry, the torch is often passed from companies like Motorola to Samsung to Research In Motion to Nokia to Apple.

That's not to say that Apple doesn't also have software. They do, and they have a fantastic installed base. I stayed with the stock through some of the trials and tribulations during their battle with Samsung a couple of years ago. But as you also mentioned, the stock was up more than 40% last year.

At the moment, it's a $724 billion market cap company, and really, it still is a one-product company. It's based on the iPhone. The iPhone is a great product, but it will be tough to match what they've done with the iPhone 6.

I'm concerned that the iPhone 6 has become an expensive product. Even here in the U.S. where cellphone plans are subsidized, an iPhone 6 Plus with a midrange configuration is a $400 device or $800 for a couple.

When contracts expire in two years, people may not be as quick to upgrade. I think the iPhone 6 had the advantage of a change in screen size, but future generations won't necessarily have that hardware innovation.

And so I think we'll see stretching replacement cycles and potentially slower future earnings growth for Apple. I would also say that their smartwatch, which is expected to drive additional growth, is going to enter a crowded market—more competitive—and certainly with fairly strong incumbents like Fitbit, Garmin, and Pebble.

So Apple has lots of strengths, and it's a very good company, but I just think it will have a tougher road ahead. And after the strong stock performance, we see better opportunities elsewhere.

OPPORTUNITIES IN MEDIA

Q: One of those opportunities is apparently the media sector, which represents about 44% of total portfolio assets. What's the appeal of these companies, and how do you see that sector developing from here?

A: In our case, media has a broad definition. We view companies like Google, which are Internet companies at their core, tech companies at their core, and fall into the media classification because most of their revenue is actually derived from advertising. LinkedIn and Tencent also fall within that media classification.

What we're really investing in, though, is the growth of the Internet and the growth of these massive platforms. I think they'll continue to have the opportunity to take share in advertising.

It's a much more effective medium. It's measurable. It has tangible ROI [return on investment]. Take a case like LinkedIn. It's virtually synonymous with job search today, so why wouldn't you advertise your jobs on LinkedIn? Why wouldn't you look for a job on LinkedIn? It's basically a professional networking and job search platform.

And what happens on the Internet is that companies have a snowball effect. You couldn't really seek a job without using LinkedIn. I think the same will happen in real estate with Zillow, which is becoming synonymous with home search.

Zillow should earn about $700 million in revenue this year, but the overall real estate advertising market in the U.S. is a $12 billion pie. So as Zillow becomes synonymous with real estate and critical to someone's home search or home sale, more and more of that $12 billion will shift toward Zillow.

A PERSPECTIVE ON VALUATION

Q: Given the strong performance in the tech sector over the past year or so, how do you generally view valuations today?

A: It varies a lot from one area to another, but to me, it's both surprising and fuel for optimism that there are still a number of relatively attractive companies on a valuation basis.

I would point to Google, for example. Google is trading below the multiple of the S&P 500 when considering 2015 and 2016 earnings, and even more so when you think about the fact that they have close to 20% of their market cap sitting on the balance sheet in net cash—plenty of fuel for share buybacks or dividends in the future.

I will say it's a much narrower set of opportunities, but fortunately, the narrow set of opportunities happens to be in some of the best companies in the industry—Google, Priceline, Tencent, Alibaba—all very attractively valued companies.

AN OPTIMISTIC OUTLOOK

Q: Josh, let's finish up with some comments on the outlook for technology investing. This sector of the S&P 500 as well as the Nasdaq Composite Index have both doubled in value over the past five years as technology has become ubiquitous throughout much of the world.

What is your intermediate- to longer-term outlook for technology now?

A: Well, it's a volatile sector, and it's one where fundamentals can differ sharply from one company to the next. So it requires careful analysis and thought

about the long term. We are trying now more than ever to really focus on true long-term winners and companies with a good 3-, 5-, and 10-year outlook.

It's been such a slow and grudging economic recovery around the world that companies can't rely on the economy to help them power through. We have to really focus on those that have competitive advantage, potential for market share gains, and potential to grow of their own accord without relying on the market to help them.

Some of these trends we've discussed are really still in their early stages when you think about the growth of the Internet, the growth of new software delivery, and the growth of industrial tech. So I think there are still dramatic opportunities. It won't be across the board, and it won't be a straight line, but I'm very optimistic about the strategy.

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