FLASH NOTE

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Looking for Disruption in Tech

Equities

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KEY TAKEAWAYS

- The identification of next **disruptive trends** will be the source of **long-term performance** for investors but the segment gathers plenty of sub-segments and **not all companies will be successful**.
- Key criteria we look for in tech investments include large addressable markets, adaptability across regions and businesses, and an ability to create **strong barriers to entry**.
- The current environment justifies an **active management of risk** that will translate in our ability to **leverage on market noise** whilst looking to buy in the best conditions the strategic winners for the future.
- **Promising segments** we like include **targeted advertising and selling**, software **data analytics** and the **gaming industry**, all of which we believe benefit from much higher growth than the broader market.

At Carmignac, we believe the ability to understand and identify disruptive technology trends and investment opportunities are the key to creating successful long-term investment strategies.

I. Looking for disruption in tech:Why? How? But...?

Why? Major trends ahead for investors

The tech revolution

For an investor seeking opportunities to generate long-term performance, it is vital to identify the next disruptive trends that will affect an existing market or create a brand new one. Today, investors are witnessing an acceleration of disruptive trends. Consumers are now able to adopt new technology at a rate never seen before. For example, it took 38 years for radio to reach 50 million users, whereas it took Internet Explorer four years to reach the same milestone. The user base for Instagram hit 50 million in just six months, whereas it took the augmented reality game Pokemon Go only 19 days.

Winner takes all

Beyond this phenomenon of accelerating tech adoption, investors are also witnessing the emergence of a completely new dynamic: the “winner takes all” where dominant players are able to capture a very large share of the rewards, thanks to a first-mover position and their ability to build powerful networks, leaving their competitors with very little. The US entertainment company Netflix is a perfect example of this dynamic. Netflix benefits from a first-mover advantage driving the highest brand awareness of the sector, therefore allowing the company to expand its user base quickly and to post better returns. This "winner takes all" dynamic emphasises the importance of choosing the right stocks in this disruptive universe. In the tech sector, not everything is an opportunity. The segment gathers plenty of sub-segments (from platforms to robotics, software, AI etc.) and not all companies will be successful.

Outperformance until when? The Nifty Fifty effect

Back in the late 1960s and the early 1970s, investors were enthralled by the large-cap blue-chip stocks nicknamed the “Nifty Fifty”. Among these names were iconic American businesses like Polaroid, Xerox, Coca-Cola, General Electric, Sears and Texas Instruments. At their peak, the Nifty Fifty were trading at 42 times earnings — more than twice the S&P 500 average[1] — and comprised almost all S&P 500 gains. If that fact sounds eerily familiar, that's because today's Nifty Fifty are the 'FAANG' stocks: Facebook, Apple, Amazon, Netflix and Google’s parent company Alphabet. So what’s the most common trait between then and now? Today, as in the second half of the 1960s, we are facing scarcer economic growth, favouring the appearance of these expensive mega caps. The number of high-growth stocks has decreased significantly in the market in recent years. To take the S&P 500 as an example, in 2002 there were three times more stocks with annual revenue growth above 15 per cent compared to now[2]. Several causes are behind this phenomenon. First, we have been experiencing lower structural global growth since the financial crisis. Second, disruptive business models have been hurting the growth profile of legacy businesses. And third, companies with completely new business models, like Airbnb and Uber, have tended to hold back from entering the stock market for much longer than before.

In addition to the scarcer structural growth context, investors are learning to adapt to a new liquidity environment. The likely impact of this on equity markets and bond yields is hard to predict, especially as market participants may be wrongly ignoring the scenario of an economic slowdown. This new uncertain backdrop should ultimately benefit growth stocks, as well as companies with solid balance sheets and high visibility, and bolster the outlook for today’s Nifty Fifty.

How? Exploiting what consensus is missing out on

The technology sector is one of the key components of our investments. We have set ourselves the task of identifying the most promising trends, not just within the tech industry but also in any sector impacted by the digital revolution. We identify trends that have universal patterns and could be easily translated across regions and businesses. We base our assessments on multiple criteria, including a large addressable market, and the ability to build a strong network to create strong barriers to entry or where “proof of concept” – a business model that is already successful in one sector or part of the world – exists. For instance, one of our current high-conviction holdings is Mercadolibre, an e-commerce platform operating in Latin America. Mercadolibre is currently developing its payment business within an underpenetrated segment in the region, by following the same successful pattern used by PayPal and eBay a few years ago.

We then make sure our investments are focused on what we believe to be the most innovative companies overlooked by the market consensus. Our exposure to the tech sector is extremely diversified in terms of geography, business and market capitalisation. We focus on high-quality companies with superior and sustainable business models, strong and predictable growth, and lower levels of leverage. Our constant quest is to capitalise on those opportunities that the consensus is missing out on.

But…Tech bubble: a déjà-vu?

The valuation question

Before seeing current tech outperformance as a potential remake of the 1999 tech bubble, one should consider the clear differences that are driving the sector today. Indeed, back then, the companies at the forefront of the tech bubble were largely enterprise-focused. Today's technology companies are consumer-orientated, providing for a much greater scope of disruption, both on a geographic and sector basis, while taking some of the cyclicality out of the tech space. Regarding valuation, it should always be related to levels of growth. These companies are deemed to offer much higher growth than the market, have strong balance sheets, and be cash generative. Therefore they share very little DNA with the big tech names of 1999/2000, many of which were simply open-ended growth stories with no valuation support.

The regulatory question

At present, the use of data collection by the FAANG companies raises a number of questions, in particular the sale of personal data for the purpose of targeted advertising. Facebook and Google, both with large advertising businesses, are under scrutiny. In this area, it looks like we are heading inevitably towards stiffer regulation. Companies will unquestionably need to set up more robust systems to manage data usage, transparency and controls. Only time will tell for sure if changes in self-governance or regulatory decisions will materially impact their earnings growth potential. While we remain vigilant, a significantly negative impact seems unlikely to us at this point. For instance, despite recent negative headlines on Facebook, we don't believe user engagement will change. In our opinion, the consensus is still underestimating the dynamic of advertising revenues, which enables Facebook to provide a return on investment unmatched across the advertising universe. After the price drop, Facebook is trading at a discount to the market multiple[3].

Recently, the whole tech sector has been lumped together with Facebook and Amazon, although many smaller firms have very different business models. This means that every correction to tech stock prices is likely to offer long-term buy opportunities to those investors able to carry out in-depth analyses of those firms' powerful, yet diversified business models.

A Head of Equities with long-standing experience within the tech sector

In recent years, Carmignac has significantly reinforced the team responsible for analysing and investing in Communications, Media, Internet and Information Technology stocks. David Older joined Carmignac as Fund Manager in 2015, with significant global expertise and experience in alpha generation. David's appointment as Carmignac's Head of Equities in 2017 further demonstrates the significance of tech for Carmignac, and the value to be gained from understanding where the best opportunities within tech lie.

II. Identifying the most promising disruptive trends in tech: two segments we like

It's all about data

In the modern world, data is a source of power. Those able to gather, analyse and utilise data to grow their business today will be the clear winners of tomorrow. The ways in which companies can successfully use data are as varied as the types of existing data available, and this variety presents several opportunities for investors. However, as with all "new paradigms", lots of questions have been raised from a regulatory, legal, fiscal, social or even political perspective. This segment will therefore go through volatility and uncertainty: it is bound to happen. But long term growth potential remains highly attractive for investors.

We have identified three main ways to benefit from these opportunities:

1. Data for advertising

Facebook and Google are dominating the digital advertising market. The two companies attracted more than 80 per cent of global spending on digital advertising (excluding China) last year[4]. Their ability to target ads is appealing for advertisers as it allows them to address their clients' needs more directly, while improving the customer experience for the user, by limiting the risk of ad overexposure.

2. Data to improve client knowledge

For e-commerce businesses like MercadoLibre and Amazon, data velocity is key to understanding and taking advantage of consumer trends. Such businesses have direct access to consumer habits and can swiftly adapt to shifts in spending behaviour, making them highly competitive.

Data is not only useful for e-commerce names. In fact, all digital platforms have a clear advantage using data compared to legacy businesses. For instance, Netflix, thanks to its direct access to consumers' viewing preferences, has the ability to provide a highly tailored offering and make targeted investments. GrubHub, the US online and mobile platform for restaurant pick-up and delivery orders, also uses data to strengthen its leading position by building a powerful network of restaurants and customers.

3. Enterprise Software data analytics

The segment enjoys a positive backdrop of increased spending from those enterprises looking to modernise and secure their IT infrastructure. The two big themes within tech (i.e. digitalisation and big data analytics) are playing in favour of the software space. Moreover, the switch from software licensing to a subscription basis mode is improving the financial profile of software companies over time. ServiceNow, a cloud-based software company targeting a $60bn addressable market, is transforming the Enterprise IT Operations Management and Enterprise Service Management mainly by ripping up and replacing legacy systems. Splunk, a clear market leader in IT Operations Analytics, as well as the Security Information and Event Management market, is attacking a total addressable market worth around $55bn. Additionally Splunk is starting to move into business analytics, which open up a new direction of growth.

The booming trend of gaming

For a large part of the population, video games are the most important form of entertainment. But this market is not restricted to millennials – the average age of a 'gamer' in the US is 35.

While people dedicate 50 minutes on average to their Facebook account every day, they're currently spending 51 minutes on PC and console games[5]. Our excitement about the segment is driven by digitalisation of the industry. The industry is shifting from focusing on the number of units sold to a model based on users' engagement and digital monetisation. As of 2017, the gaming industry is valued at some EUR 100 billion and is outgrowing other media with an annual growth rate of 9 per cent[6].

Just a few years ago, video game companies were still earning most of their revenue just after the initial release of a new game. Now, there are many different revenue-generating variants and multiple ways to acquire mobile gamers, as console games can follow-up with an app to integrate smartphone users, thanks to add-ons and in-game purchases. There is, in addition, a growing demand for live streaming of video game competitions. Game publishers have successfully managed to boost levels of engagement, as both user growth and frequency are strong, causing them to generate revenue more steadily than before. We therefore see less cyclicality in the business and margins rising.

We believe that tech companies will continue to benefit from much higher growth than the broader market, due to strong balance sheets and predictable earnings. However, for all of the reasons outlined above, the current environment justifies an active management of risk that will translate in our ability to leverage on market noise with the aim of buying in the best conditions the strategic winners for the future.

Source: Carmignac, Bloomberg, April 2018

1 2 3 4 Sources: Bloomberg, March 2018

5 6 Sources: Morgan Stanley Research, 2017

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