MARKET INSIGHTS

March 2011

Why invest in the technology sector?

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Greg Tuorto, *executive director,* is a co-manager of the US Technology Fund and technology analyst in the US Equity Group. Before joining the firm in 2008, he was a senior analyst covering technology for the Small and Mid Cap Group at Jennison Associates. Prior to that, he was a technology analyst and small cap portfolio manager at The Guardian Park Avenue Funds. Greg was also a technology analyst, focused on small and mid cap equities at the Dreyfus Corporation and Tocqueville Asset Management. He holds a BA from Catholic University and an MBA from Monmouth University.

Introduction

The tailwinds behind the technology sector are building, which could lead to strong earnings growth and positive stock returns in 2011 and 2012. There are four major themes that point to strong fundamentals within the technology sector:

- *IT spending growth rates are currently much stronger than the average levels seen over the past decade and this extra spending is being allocated to areas of innovation as companies strive to expand.*
- *Excitement is growing over strong demand for new devices like smartphones and tablet computers.*
- *The health of the global economy is improving, which is creating a favourable climate for a large scale increase in capital expenditure.*
- *Valuations in the technology sector remain attractive, particularly for companies with higher growth rates. A negative bias within the analyst community leaves room for upside revisions to sales and earnings estimates.*

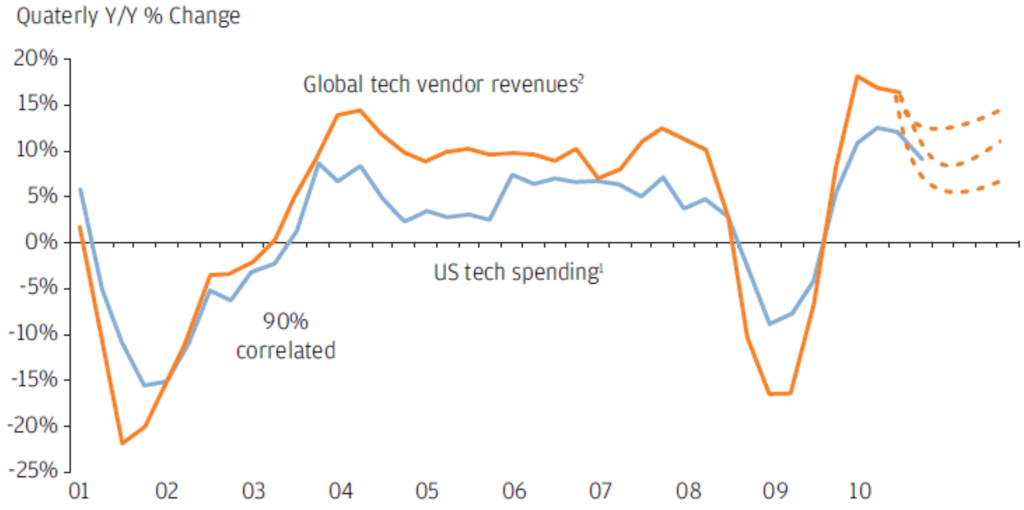
I. The return of IT spending

For most of the last decade, technology spending has been severely restrained. Much of this is a hangover from the dotcom boom and the massive spending associated with Y2K preparations. With spending severely depressed, many promising technologies in networking and storage struggled to find traction.

During this period of austerity, the mantra of the Fortune 500 Chief Information Officer was ‘do more with less’ and ‘cut, cut, cut’. This led to the development of a patchwork of proprietary technologies that didn’t talk to each other. As the purse strings loosened in 2006-2007 and spending increased, companies moved to integrate and consolidate many of these proprietary technologies. However, although the overall level of spending rose, the net benefit to technology companies and to end users was negligible.

This situation is now changing. Technology spending is not only increasing, but the biggest spenders in 2011 and beyond are likely to come from a broad range of industries. We are already seeing signs, for example, that manufacturing companies, healthcare companies, media companies and pharmaceutical

Exhibit 1 – **Global technology revenues have stabilised and point to a stronger second half**



[1] Current dollars, seasonally adjusted annual rates; [2] based on 78 IT companies
Source: Bloomberg, Companies, Commerce/BEA, ISI

companies are embracing the new tools and modalities that are being made available by Cloud Computing[1] to enable their workforces to drive sales growth, develop new products and services and improve the efficiency of the corporation.

There is also a high correlation between the rise in IT spending and the rise in overall corporate revenues. We are currently seeing this correlation begin to manifest itself within fourth-quarter 2010 revenues. We believe this correlation is also positive for technology investors as it usually leads to outperformance from technology stocks.

When companies add to their IT spend, we think it will benefit the growth areas of the technology sector. These are the types of technologies we like to invest in, as they are seeing inflection points in demand and adoption. Early corporate adopters of Cloud infrastructure services, efficient storage arrays and sales force enablement systems tend to see a rise in their market share as a result of being first to market and ahead of the competition.

[1] Cloud Computing allows companies to access databases or software hosted by a third party over the internet. The technology can help companies integrate across global boundaries without investing in expensive IT infrastructure.

We like the prospects for areas such as virtualisation, wide area network optimisation, tablet computing and enterprise wireless over the next two-to-three years. As already discussed, the Cloud (or the delivery of computing services over the internet) is also an increasing focus for us.

The emergence of the Cloud is positive for technology investors, creating a host of opportunities. However, instead of trying to find companies that are 'pure plays' on this theme, we are identifying companies that are participating in the semiconductor, storage, service provider and infrastructure trends created by the growth of Cloud computing.

II. Increasing demand for mobility

There are many aspects of the mobility theme that interest us. The advanced technologies in many new smartphone models and tablets have led consumers and businesses to question the need to purchase PCs or Notebooks. In the most recent quarter Apple, the runaway leader in the smartphone and tablet market, sold more than 16m iPhones and 7m iPads (source: AAPL 10Q, 19 January 2011).

This growth has been achieved despite many news reports that new versions of both devices were coming soon and a new major carrier was going to be added to the network. The numbers showed a level of pent-up demand that is price inelastic. This is unlike any other phenomenon we have seen in the technology space in our careers.

Morgan Stanley projects that Apple could ship as many as 40m iPads and 100m iPhones in 2011; we think they may exceed both of those numbers. We also have a number of challengers in the tablet space which should be able to produce 3-5m tablets for consumers who are not interested in Apple products. We think smartphone penetration may pass 25% this year and tablet penetration may approach 8-10%.

These dynamics will have a major impact on media consumption, social networking, e-commerce, mobile payments and collaboration. We have spent a lot of time identifying the potential winners in this space and feel that investors can capitalise on this trend in many different ways. Additionally, our analysis has kept us away from companies that are horribly out of date in their product strategy.

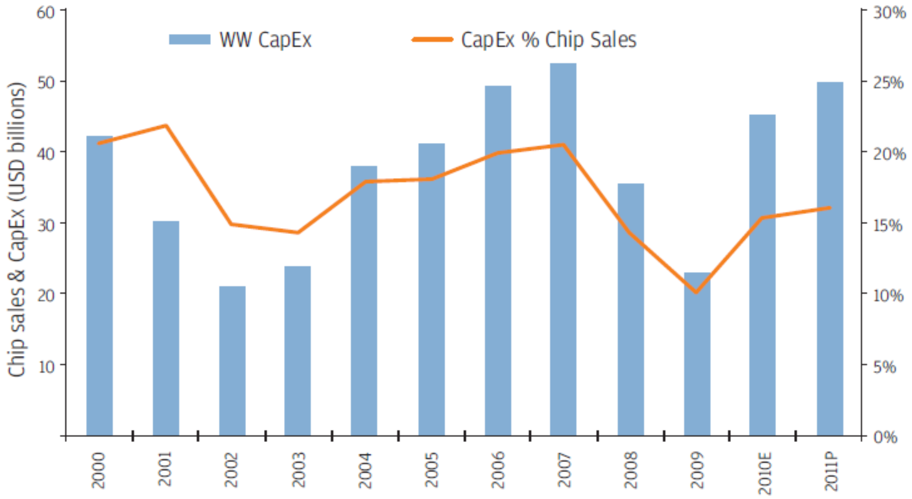
The mobility trend is proliferating at a faster pace than most can comprehend. There are new models that pop up daily to take advantage of rich feature sets and multimedia capabilities. We have seen a few companies emerge in recent months to participate in the tablet/smartphone market and we expect many more to emerge in the future.

III. Improving global economy leading to longer-term capital expenditures within technology

There is now a good reason for companies to boost capital expenditure (capex) and spend their significant cash coffers. In the US, the federal government is extending the research and development (R&D) tax credit which many technology companies have lobbied for. The tax credit will be used extensively to plan for the growth of their operations for years to come. We are only just starting to see the confidence from corporate managements needed for them to make these types of multi-year investments.

Consider the case of the semiconductor industry. Intel (INTC) is facing a number of challenges due to its lack of a processor in the tablet space. Rather than try to buy its way out of trouble, Intel has decided to spend USD 9 billion on new plants to produce faster, more reliable power efficient chips for the tablet market. This level of investment was a massive shock to most investors, as it was about 40% above what analysts had forecast.

Exhibit 2 – **In the past rising capex has led to a higher proportion of capex going to the technology sector**



Source: ISI, 31 December 2010.

Other semiconductor companies, such as Taiwan Semiconductor, have been forced to raise their game and spend similar amounts on wafer production equipment in order to compete against their large US competitor. Capital intensity is rising faster than most market participants expected. However, we view this sharp rise in spending as an interesting inflection point in which to invest and have taken meaningful positions in semiconductor capital equipment companies in our growth portfolios.

The telecoms sector provides another interesting example of the return of the capex cycle. AT&T and Verizon have been using network quality issues in the public domain to try to win more subscribers. As AT&T has lost exclusivity of the iconic iPhone in the US, it has turned the intensity of its capital expenditure budget more toward easing congestion in its network, which is slowing down data usage. Verizon, meanwhile, has gained a reputation for quality on their network, but to maintain this reputation amid ever increasing mobile traffic, they will have to spend increasing amounts of money on updating their mobile network. These capital outlays provide an insurance policy to help protect a company's reputation and also can be seen as investments to guarantee future revenues.

We have looked at many ways to invest in the capex trend and are finding opportunities in software, components and large systems. The capex trend is something that we feel will be a major tailwind for technology stocks for some time to come.

IV. Valuations

There are some concerns that technology stocks are expensive at current valuation levels. Mainly these concerns have arisen because many investment managers have trailed their respective benchmarks after refusing to invest in technology stocks with strong operating momentum.

There are two main reasons why many investment managers failed to invest in these market-leading stocks. First, many of the market leaders in 2010 were in the small and mid-cap segments of the market as opposed to the traditional large-cap companies. Second, the price-to-earnings (P/E) multiple on many of these stocks was higher than the market, which was not attractive to many investment managers who were focusing on cheaper stocks in the early stages of the economic recovery.

Last year the stocks with strong growth characteristics outperformed companies whose growth rates were nearer to the market average. In fact, the technology stocks with higher than average growth rates advanced by more than 25% during 2010. We believe these companies should be able to continue to expand their valuation multiples, supported by sustainable revenue growth rates. Therefore, these fast growing technology companies should maintain their premium over the rest of the market.

Exhibit 3A – **Median tech forward P/E**

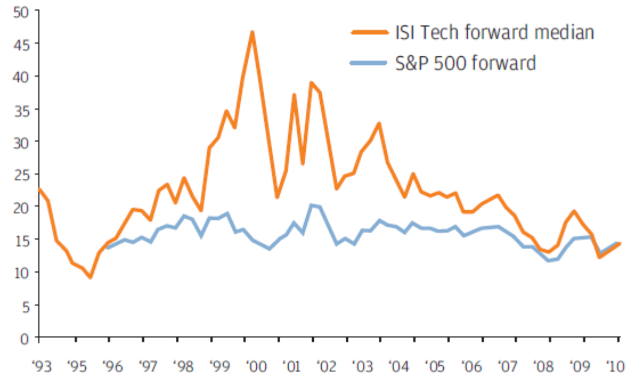
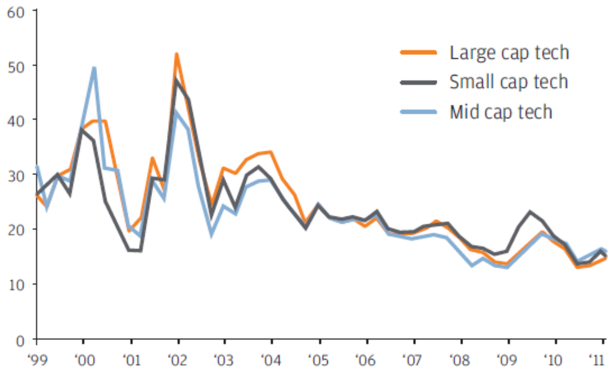


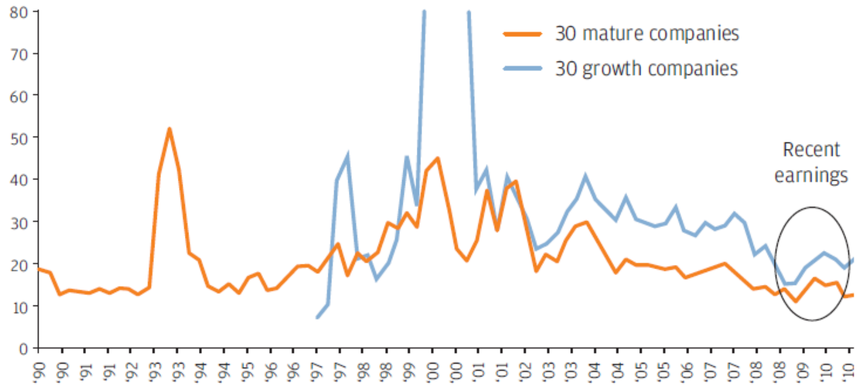
Exhibit 3B – **Small & mid-cap tech forward P/E**



Source: ISI, 31 December 2010

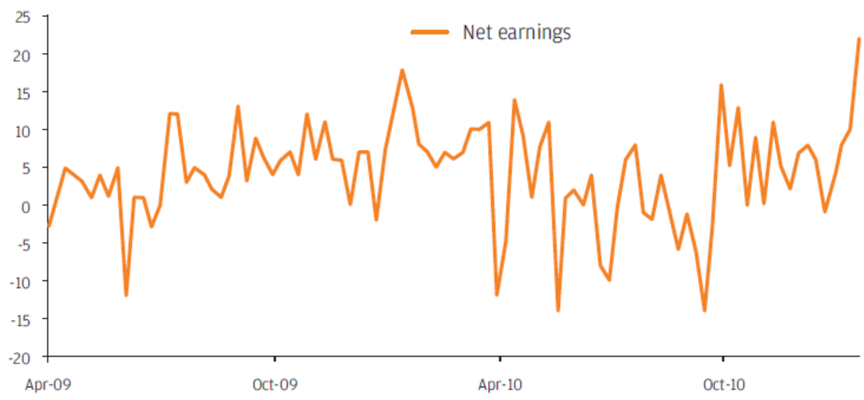
The guidance from technology companies reporting fourth-quarter earnings has been positive, with strong revenue growth rates and margin expansion leading to upward revisions. We believe many broker estimates remain too conservative, reflecting caution following other failed technology revivals since the internet bubble.

Exhibit 4 **– Median tech forward P/E, top 30 growth and bottom 30**



Source: ISI, 31 December 2010

Exhibit 5 **– 2011 tech earnings revisions turning positive**



Source: FirstCall, FactSet, ISI Analysis, Bottom Up S&P Tech. Internet since 2Q03 only.

Analysts have been reticent to project forward the current success many companies are seeing because they are assuming that there will be a major competitive response from larger, incumbent vendors. Alternatively, analysts are assuming the economic recovery will run out of steam and lead to a reversal in demand for technology products.

Conclusion

We feel we are entering a multi-year outperformance phase for the technology sector and are excited by the thematic and fundamental opportunities currently available. In particular, with an improving macroeconomic backdrop and investment spending picking up across the Fortune 500 we think the amount of cash allocated to technology projects will rise faster than many expect.

The strong demand for tablet computers and smartphones is also creating many peripheral opportunities in areas that are new to many investors.

As a result, the technology sector may be entering a phase similar to the mid 1990s where innovation and aggressive strategies will be rewarded. We have a lot more faith in end market demand than the sell-side analysts.