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TECHNOLOGY AND DEMOGRAPHIC TRENDS IN 2018

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- We expect corporate earnings to grow by around 10% in 2018, but also recognise that valuations are not cheap.
- Technology remains an important theme. Against a backdrop of changing demographics, it is crucial that companies and investors get technology right.
- While many believe technology has grown to the point where it is over-valued, we should arguably be looking to the sector for faster growth as well as unexpected growth that the market hasn't yet discounted.

The global financial crisis was a major shock to the system, but earnings have recovered sharply and are continuing to grow amid a global economy that appears to be in rude health. Equities in particular have outperformed and 2017 marked the eighth consecutive year of the equity bull market. While we still believe there is more potential in equity markets, it seems obvious that alpha is going to become much more important as we go forward – and the market correction seen in early-Feb 2018 indicates that we will see spikes in volatility from here.

While we expect corporate earnings to grow by around 10% in 2018, we also recognise that valuations are not cheap. And there is one thing about this recent bull market that has been very different to all others – no one has enjoyed it.

TECHNOLOGY IS THE DOMINANT THEME

With that in mind, it is perhaps more interesting to talk about themes we are seeing in markets – and as bottom-up investors we are well-positioned to spot trends at the microscopic level. Clearly, one of the overriding themes we have seen in recent years is the pace of technology, the speed with which corporates and individuals are adopting technology, and the impact it is having on businesses.

Technology is important because it changes businesses. If you can innovate, you can generate a phenomenal source of competitive advantage in the modern world. As adopters of Porter's Five Forces, we are well aware of the impact of economies of scale, specialised knowledge, technology protection, and barriers to entry – and technology delivers all of these factors. Technology in previous cycles would have meant investing in a hardware company that would only be able to harness a short-lived competitive advantage. Today, the likes of Google can dominate for the foreseeable future – and that is sustainable competitive advantage, driving high returns on invested capital.

Within technology, we are also seeing 'sub-trends' driving potential returns. For example, we know that research and development can drive competitive advantage, and we also know that a majority of forecast R&D expenditure for the next five years is being allocated to the technology sector. So while many believe technology has grown to the point where it is over-valued, we should arguably be looking to the sector for faster growth as well as unexpected growth that the market hasn't yet discounted.

In terms of sector weightings, our biggest overweight is still technology but it is materially lower than it was. Stocks are not quite as cheap and we also see compelling stories in the likes of financials now, where the banking sector has arguably yet to fully recover from the global financial crisis. But to ignore technology would be foolish.

SUSTAINABILITY

Technology is also about sustainability. Taking Alphabet (Google) as an example, the company has grown revenues at 31% compounded and depends on users continuing to use Google as their predominant search engine for its success. Will they? It is highly likely they will, given the company spends up to $14 billion a year on research and development; while Yahoo spends a fraction of that. Arguably, value investors might buy Yahoo while realists would buy Google.

But investing in technology is also about valuations. Looking at 2019 estimates, the free cash flow that Google will generate is 5% of its market capitalisation (which is $770 billion), so that is a 5% free cash flow yield on 2019 estimates growing at over 20% per annum. Is that expensive?

In terms of advertising dollars, UK commercial TV network ITV gets $45 of advertising revenue for every man, woman and child in the UK every year. In Europe alone, Facebook generates $26 off users, which means that to get to ITV's level, the social media company has 75% revenue growth still to come.

Amazon thinks differently and is challenging and dominating businesses every week. Amazon Web Services (AWS) alone is a $20 billion revenue business growing at over 40% per annum with margins of over 30%. It is clear that the cloud is a growing sector, with both individuals and businesses likely to use the cloud with increasing frequency in the future. All of these examples indicate that technology, in tandem with changing demographics, can be a sustainable source of competitive advantage, driving ongoing returns for investors.

CREATIVE DESTRUCTION

There is a dark side. Clearly, technology can be used in a positive sense but it is also worth paying heed to Joseph Schumpeter's 'creative destruction' model to see the flipside of technology. Schumpeter believed that in capitalist economies, companies develop a certain way of doing things until something better comes along that destroys the old way. While Schumpeter argued that this could eventually lead to capitalism collapsing, which hasn't happened yet, there are plenty of examples of technology destroying companies and industries.

Newspapers may not be around in 20 years' time, Blockbuster Entertainment perished as people no longer needed to go to the video store to rent movies. As companies are destroyed shareholders can often follow the spiral down, always believing that with every new low that value is being unlocked. But in the end there is no cash flow, no earnings, no business. Mean reversion can be very misleading during a period of creative destruction. At a style level, it can lure value investors into avoiding quality growth companies in favour of ailing entities.

TREND SPOTTING

In the US, cable subscriptions are declining rapidly – NFL viewing last year fell 10% – and advertising executives are seeing better returns on their dollar spend online at the same time as TV advertising is losing market share. Many are aware of this trend, but we try to look beyond current moves in technology. For example, eSports (competitive, multiple player sports videogaming) is set to explode. The National Basketball Association (NBA) has 60 million viewers in the US and it monetises each viewer at a hundred dollars per annum. eSports has 50 million viewers and these players are currently only monetised at $9. In our portfolio we hold the likes of Nintendo and Activision and we believe they will unlock revenue streams that are not even in people's forecasts yet.

It is crucial that companies and investors get technology right because technology changes and shifts in business models drive Return on Invested Capital (ROIC) and shareholder returns. Against a backdrop of changing demographics, where lifestyles shift quickly and consumer trends are fast moving, this is as important as ever.

Businesses that can harness technology to drive competitive advantage, and in turn high ROIC and total returns for shareholders, will be the winners. As technology becomes a more influential source of competitive power and ROIC, we must remain aware of what it can do, what companies' barriers to entry are, and their ability to process these technologies.

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