

**Fund manager update:
IT upgrade cycle points to dramatic return for the forgotten sector**

17 December 2009



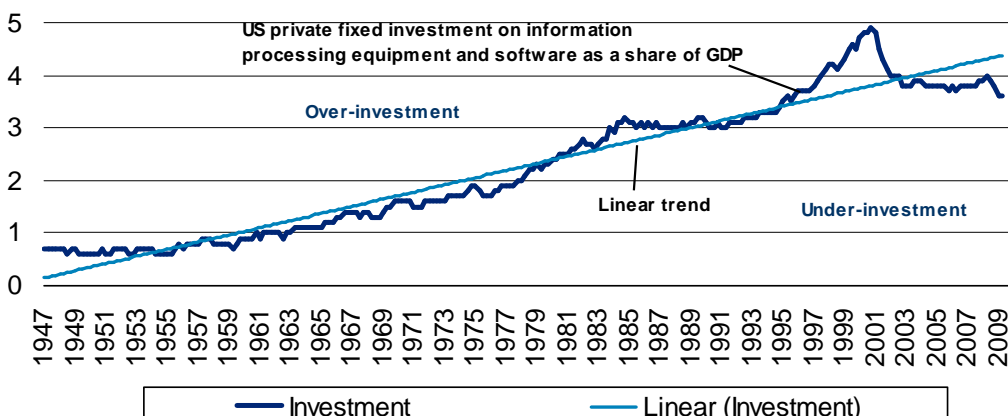
In this fund update, Stuart O’Gorman, co-manager of the Henderson Horizon Global Technology Fund, explores some of the key themes that he believes will generate growth within the technology sector during 2010 and beyond.

In 1965 Gordon Moore, the co-founder of Intel, predicted that the number of transistors on a microchip would continue to double every two years, and that "cramming more components onto integrated circuits" would see information technology (IT) advance at a rapid but constant pace. Forty-five years later, Moore’s Law continues to hold true and with a paucity of growth options in the rest of the market, the technology sector appears to be favourably positioned for 2010.

The demand for technology comes largely from two key areas: companies investing in IT infrastructure and consumer appetite for user-friendly electronics. The cyclical and global nature of the technology sector results in higher investment in technology during an economic upturn and tighter economic spending during a downturn. The opportunity within the technology sector at present lies within the realisation that the sector has been experiencing its own particular downturn since the ‘tech bubble’ burst back in 2001.

Whereas most companies have been forced to rein themselves in over the last couple of years, in the technology sector spending has been constrained for almost a full decade. The huge increase in spending around the turn of the millennium proved a disappointment for most companies as the technology purchased was not capable of delivering what was promised. Ever since, IT budgets have been under severe pressure. During the credit bubble of 2003-2007, while the rest of corporate-exposed spending was booming, technology spending was kept to the bare minimum.

Chart 1. Technology spending over the long-term



Source: Nomura, Bureau of Economic Analysis, as of September 2009

Is corporate IT spending set for an increase?

As Chart 1 demonstrates, corporate spending on IT hardware and software is currently some way below the linear trend. We believe this low level of spending is unsustainable and with continuing improvements in the business climate, companies are poised to start spending on technology once again. The IT infrastructure of many companies is ageing at a dramatic rate and it will be increasingly difficult for companies to put off replacement any longer, given increased maintenance and repair costs. In addition, because of the long delay in upgrading their IT infrastructure, the functionality improvements now offered by replacement equipment are dramatic, in many instances managing to effectively pay for themselves in less than a year.

Companies are starting to feel datacentre pressure

We live in the 'information age', and every year more and more data is generated that has to be stored and accessed by corporations and individuals. This is done via datacentres, large warehouses crammed with expensive technology such as routers, servers and storage devices. Datacentres consume a huge amount of energy. For example, a large data centre (of which there are many) has an energy consumption rate comparable to a city of 50,000 inhabitants. This obviously is very expensive (as well as harmful to the environment) but there are ways of addressing this problem.

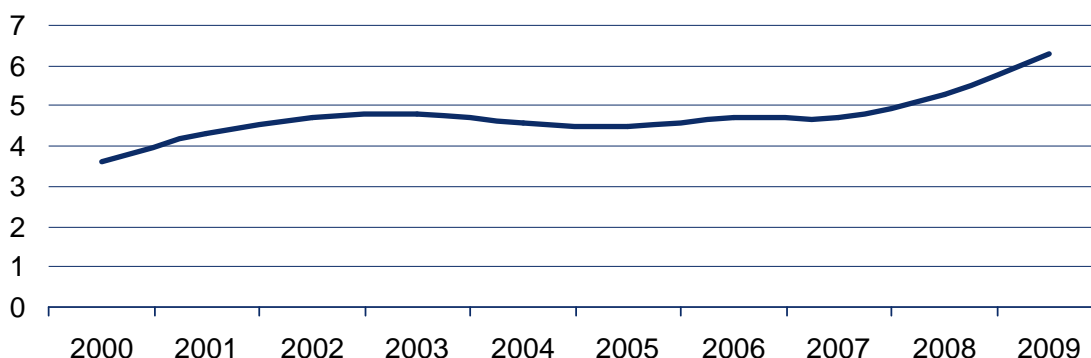
It is estimated that by replacing old servers with the latest technology a company can reduce the number of servers needed by a factor of four. Companies stand to benefit greatly in terms of costs, reliability and speed. Power consumption can also be greatly reduced, and it would drastically lower a company's carbon footprint. There would also be considerable savings in terms of man hours and operational and maintenance costs.

The pace of upgrading datacentres has been slower than one would expect given the potential savings on offer. Why? Most corporations were at the point of accelerating their spending in 2007 but the recent financial melt-down caused most companies to delay or cancel even the most compelling capital investment projects. Monetary conditions have now eased and there is some resources available to be spent on pressing internal projects such as this.

The upgrade cycle for personal computers (PC)

The PC sector may also be on the verge of a major upgrade cycle. Most companies and consumers were reluctant to replace their PCs during the past few years, due to the dreadful performance of the Windows Vista operating platform. This reticence was further aggravated by the bursting of the credit bubble. The average age of the installed base of corporate PCs is over six years. Deutsche Bank estimates that when a PC is more than four years old, it is cheaper to buy a new PC than repair it. In addition, as most corporations chose not to upgrade their PCs they are still running Windows XP but support for XP will expire in 2014. Companies are now thinking about the business risk associated with running an out-of-date operating platform which offers no technical backup support. Pressure is therefore mounting and we think that the upgrade cycle will begin in earnest in the latter half of 2010.

Chart 2. Average age of desktop PCs (in years)



Consumer spending habits are evolving into new areas

Technology as an investment sector continues to be somewhat underappreciated by investors, who tend to view tech spending as entirely discretionary and indeed un-necessary. This has a lot to do with the average age of investors, many of whom are over 40 and have a lower marginal propensity to consume technological goods. However, each year the demographics of the population are shifting towards the IT sector, Consumers in their teens and twenties are hungry for new applications and services such as mobile phones, instant messaging and Facebook are viewed by this generation as necessities. These are now of course no longer 'big ticket' items for consumers, as prices have been aggressively cut both in the West and also emerging markets. This is already causing severe dislocations in many consumer-related markets and we believe they will spread and intensify going forwards.

An example of this would be the iPhone application RedLaser, which shoppers can use to scan the barcodes of products they are interested in. The application then takes the browser through to price comparison websites where they can find the product cheaper online. Users can complete the purchase from a competitor and arrange delivery before they even exit the shop. This is a great application for price-conscious shoppers, but also represents a serious new threat to the high street. No wonder high street chains are rumoured to be mulling over ways to obscure barcodes from their customers.

A similar cultural shift is taking place within advertising, where budgets have been stripped back considerably in most sectors over the past couple of years. The dilemma facing marketing departments is a simple and long-standing one: how do they make their advertising spending quantifiable and therefore justifiable? Whereas TV advertising, print media and billboard spending offers up only anecdotal evidence as to its effectiveness, new advertising avenues such as Google's keyword search offer visible payback at a fraction of the cost of traditional media. Companies only have to pay Google if browsers click through to the company as a result of their keyword spend, allowing them to adjust their advertising budget on a day-by-day basis, change their keywords at short notice and keep track of the hit rate with their target markets.

Summary

Past experience teaches us to avoid getting over-excited about the potential of the technology sector. That said, tech looks attractively valued when compared to most other sectors. Companies have shrugged off the irrational valuations of earlier in the decade and what remains within the sector are much akin to traditionally defensive holdings: namely well-managed businesses with strong market share and little or no balance sheet debt. On the whole, corporate and consumer spending is likely to remain patchy in the year ahead, but technology appears to be one of the few areas offering genuine growth potential.

Stuart O'Gorman**16 December 2009**

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