

For professional investors only

Technology sector performance

The MSCI AC World Technology has fallen during the recent market rout, although, as we predicted, it has fallen by less than the MSCI World Index as the defensive qualities inherent in high quality large cap technology stocks came to the fore. However, we have witnessed a complete and utter collapse in small and mid cap technology stocks. The problem has been a lot of these alleged secular growers, trading on high valuations have been only meeting, or indeed missing, their numbers and blaming the economy. The issue with this is that a) they were priced to beat and raise earnings expectations, and b) the whole story these companies peddled to investors was that they were economically insensitive. If they are now confessing that the economy actually does impact their businesses, the story is not quite the same and they now are in the process of re-rating to be valued more like growth cyclicals – a very painful process indeed.

While we think that value is starting to emerge in certain select names, we believe it will be very difficult for these previously highly valued names to get back up to the multiples they previously traded on as the true nature of these companies has been found out. It is therefore less likely that we will see the almost unprecedented outperformance of small/mid cap technology that we saw during 2009 and 2010.

Market predictions

At the moment we are getting mixed signals from the demand side with many technology companies still not seeing a slowdown in demand, as witnessed by strong results from many names especially late cycle businesses in the software and services sectors such as Oracle, SAP, IBM, Cognizant and Accenture to name but a few. However, some of the earlier cycle businesses, such as semiconductors and communications equipment have seen poor results, as have many that have a large exposure to government spending. If market weakness continues it may become a self fulfilling prophecy as capital expenditure decisions will be delayed, causing more market weakness and more delays, running the risk of spreading the malaise gradually everywhere.

In this environment there is a likelihood that the monetary authorities will do everything they can to bail investors out of bad investment decisions, hence another round of money printing is almost certainly around the corner. The Fed's (and other central banks) new mandate seems to be to protect the stock market at any cost (for the reason given above). Again, a short to mid-term rally is highly likely, especially as markets do look heavily oversold. Unfortunately for the longer term, as we have said many times before, this is a 'drug addict economy'. Increasingly bigger fixes are needed each time and the effects are less and less potent. We are slowly but surely approaching the situation described by John Maynard Keynes where monetary policy becomes akin to "pushing on a string". The problem being that monetary policy stops working when confidence nosedives, and the solution may have to be fiscal (with eventual monetisation of the resulting debt). This seems to be the exact opposite to the policy step that governments are taking with austerity packages gradually being rolled out across the Western world, which makes us increasingly concerned.

Portfolio positioning

We are going to continue to bias the portfolio heavily towards companies with strong barriers to entry, strong balance sheets and reasonable valuations. We do see some compelling value in certain technology names especially within our preferred themes of e-commerce, internet advertising, connectivity, data growth and electronic payments. However, we are not joining in the chorus of technology fund managers claiming their favoured names are immune from the economy – while there are some very interesting secular growth stories in technology, it is a very rare stock that is entirely immune. Sadly, given the macro headwinds we believe the economy faces, especially in the long-term, we need to take this into account. Therefore we will maintain a reasonable balance of cash until we see signs of some sort of believable solution to the current economic environment. We are, however, cognisant of the desperation of central banks and governments to inflate markets and may tactically reduce the cash levels if we believe another major stimulus package will have a more than transitory effect. Additionally, if valuations get cheap enough in specific companies we will also look to deploy the cash.

Technology - relative outlook

We firmly believe that technology presents a compelling risk-reward choice for investors within the equity sector both in rising and falling markets. This is due to:

- 1) Some genuine secular growth stories in the themes identified above that, while not immune, will be less exposed to any poor economic scenario.
- 2) Very healthy balance sheets
- 3) A high degree of recurring revenue for many technology stocks
- 4) Flexible business models of many technology companies in the medium-term (many have no factories or unfunded pension liabilities and much of the compensation is either bonus or stock based)
- 5) Pent up demand due to under-investment in the wake of the technology bubble – remember we were the only sector not invited to the credit bubble party.
- 6) Demographic shifts causing consumer spending to gradually skew more towards technology

Stuart O’Gorman, 11 August 2011

Henderson Horizon
Global Technology Fund
Update

For further information on the Henderson Horizon fund range please contact your local sales office or visit our website: www.henderson.com

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