Investing in the Technology Sector in 2017

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Much fanfare has been thrown around over the past couple of years about the lopsided concentration of returns that technology brings to our markets.

The old acronym FANG (Facebook, Amazon, Netflix and Google), or the newer FAAMG (Facebook, Amazon, Apple, Microsoft and Alphabet), are being bandied about as creating a top-heavy market that is precipitously close to falling.

With global growth meandering in the 2-3% range and constant ETF flows going into large cap indices, there has been a convergence between momentum, indexation and growth style factors that has driven capital to large caps (FANGs/FAAMGs). This has led to the interesting situation of lower realized volatility in this group of stocks compared to even the Consumer Staples sector. It is reasonable to think, "How could this not end badly?"

Common arguments like "Paying 30x earnings is expensive!" and "The P/E is over 200x on Amazon!" have been lobbied about for certain high-growth businesses and raises the question, "How can these valuations be reasonable?"

While the criticisms are understandable, spending more time below the surface reveals a different picture when weighing not just the valuation, but also the business quality.

In a decade we might say that the absolute valuation levels today, were too high. However, if you needed to be invested today, is it not more important to compare them to what you get by owning the S&P 500? If so, the picture may not be as grim as one might think.

First, let's compare FAAMG to the tech bubble when Microsoft, Cisco, Intel, Oracle and Lucent were the large constituents in the index. Back in 2000, those five names constituted 15.8% of the index value, while today this figure hovers around 13%, which is slightly above the average for the past decade, but not by much.

Valuation today is less than half of valuations during the tech

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bubble with 2018's expected P/Es ratios averaging the low 20s with free cash flow yields anywhere from 3% to 8% for FAAMG.

One exception of note is that Amazon's P/E is at 60x, which is unrepresentative of its true earnings power. This is compared to tech bubble stats of sub 1% free cash flow yields and earnings on a forward-year basis averaging over 60x. Companies today also now have nearly 7 or 8 times more cash on the balance sheet as compared to companies during the bubble. Comparatively, the S&P 500 today is trading at 17x 2018 expected earnings and generally has a mid-single digit revenue growth versus companies such as Facebook that are growing over 30% annually.

FAAMG may not be a cheap basket of securities, but it is one that generates well over triple the revenue growth with a significantly higher return on investment compared to the index.

Currently there is a very reasonable justification for the fact that paying a few multiple points higher on expected earnings one year from now might just be worth it.

Large Cap growth companies like Facebook are not just an American phenomenon. There are numerous global businesses that are completely dominant in their field, enjoying competitive advantages and eye-popping growth. Tencent in China is experiencing the same dramatic changes that Facebook's advertising business experienced between 2010 to today. Its core product "WeChat" has over 938 million highly active users that spend roughly 32% more time inside the app when compared to Facebook, while Tencent is only earning 20% of what Facebook generates per user for advertising. They additionally have significant potential with the other product offerings inside the app, including media subscriptions, music, games, payment processing, and E-commerce.

Imagine combining Facebook, Netflix, PayPal, YouTube, Spotify and Nintendo into one company and selling all of these offerings conveniently in one place to most of Southeast Asia.

Much like Facebook, Tencent is not cheap at approximately 32x 2018 expected earnings, and yet it is still growing at over 40% and earning in excess of 30% on its investments. Are you convinced yet?

The common arguments against these companies that I have listed above focus on valuation without digging deeper into business quality.

Markets are not completely irrational beings; they weigh every business on a scale, balancing the price you pay on one side to the quality of business and reinvestment opportunities on the other.

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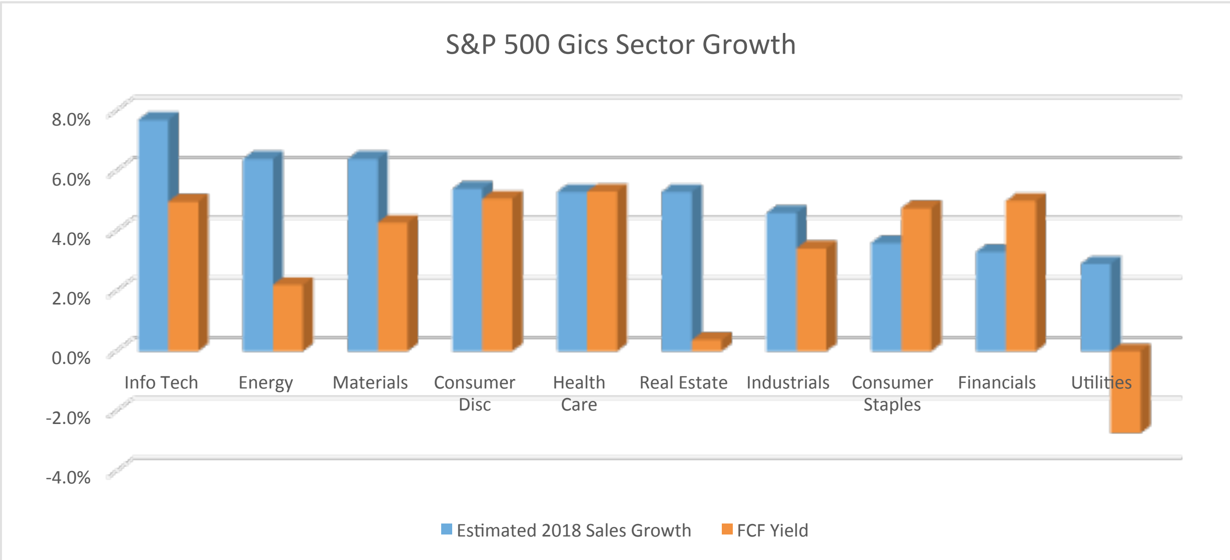

Source: Bloomberg L.P. (2017). Estimated 2018 Sales Growth ; Operating Margin; Return on Equity; FCF Yield for the S5INFT Index; S5ENRS Index; S5MATR Index; S5COND Index; S5HLTH Index; S5RLST Index; S5INDU Index; S5CONS Index; S5FINL Index; S5UTIL Index. Retrieved September 28, 2017 from Bloomberg terminal.

Whether a business is trading at 10x earnings or 30x, the goal of investing is to get more than you pay for (regardless of the multiple). Just focusing on the valuations alone may preclude you to miss certain investments.

A poorly maintained Ford for $15,000 may be overpriced, while a well-maintained Ferrari for $80,000 could be a steal. The hunt is about investigating each factor. As long as you understand that you are making a quality investment, it may not matter how relatively expensive it was, depending on what you are getting in exchange. If you are paying a bit more than the market, your hunt is to find businesses that can reinvest and grow over the coming decades faster than those of the average company in the index.

Like every investment, the tried-and-true rules of investing still apply.

Businesses must generate cash flow, be managed by competent and able executives, and have opportunities to reinvest profits back into the business. The biggest differentiator is the focus on future opportunities rather than the current run-rate business.

Like always, there are significant risks with any investment due to wrong assumptions, tax rate adjustments, government, potential anti-competitive regulations or changes, and general competition. This is why our funds, with all else being equal, continue to be overweight Technology and Health Care. While it may be ideal to get high-end champagne for the price of a beer, sometimes you may just have to pay a bit more!