THE DRIVE YOU DEMAND

A REGIME CHANGE AHEAD FOR GLOBAL TECHNOLOGY

Spotlight

UBP

Union Bancaire Privée

Global Investment Committee

Key points

- *15% per annum returns since 2010 in global technology was driven by a combination of BOTH strong earnings growth and PE expansion*
- *A new regime is emerging in 2018 with performance year-to-date characterised by contracting PE multiples offset by exceptionally strong earnings growth*
- *While investors should expect more volatility in the sector under this new regime, continued strong earnings growth should support attractive, although more modest absolute returns*
- *Investors should pivot from passive, index-oriented technology exposure and instead seek to benefit from active management opportunities that should arise in the technology space*

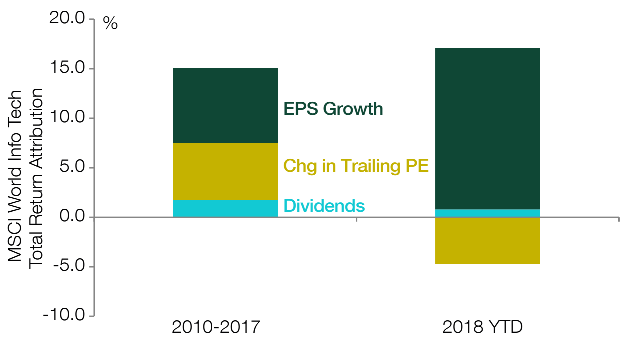
An evolution in return drivers for global technology

Since the 2008-09 Global Financial Crisis, the global technology sector has delivered an impressive +15.4% in annual returns easily outpacing global equities as a whole (+10.2%) and even growth-oriented equities around the world (+11.5%).

2018 appears to be no different with global technology shares rising almost 12% through end-July well ahead of their growth-oriented peers (+7%) and broader global equities (+4%).

However, underlying this performance is a shift in return drivers which should be key to the forward return profile of the sector. Prior to 2018, investors in the sector benefited from three-pronged return drivers, with earnings, dividends and PE expansion all adding to total returns.

Global Technology: PE expansion no longer a positive contributor to returns in 2018



Source(s): MSCI, Bloomberg Finance L.P. and UBP

While many investors are right to believe that earnings growth has been the key driver of returns in the technology space since 2010, earnings actually accounted for only 49% of total returns. While a substantial driver, in contrast, PE expansion was a significant driver itself, accounting for 37% of total returns over the period.

Focusing on YTD performance, the return drivers have shifted dramatically. In 2018, earnings growth has driven by far the largest proportion of all of the returns generated by global technology investors. PEs, on the other hand, have shifted from being a key driver of returns to now serving as something of a headwind (see chart).

Looking forward, it appears unlikely that PEs can sustainably resume their role as a positive return driver for the technology sector as has happened since the Global Financial Crisis. Outside the early-2000s bubble in technology stocks, the global sector has trended near 22-25x trailing earnings in non-recession/crisis periods in the global economy.

Global Technology: PE re-rating from 2012 should be nearly complete

Source(s): MSCI, Bloomberg Finance L.P. and UBP

It has become apparent that the ability of the technology sector to rely so heavily on PE re-rating to drive returns in the years ahead appears constrained, in the absence of a repeat of the early 2000-style bubble seen in the sector.

An earnings focus = more volatility for Technology

As seen recently, a greater reliance on earnings growth to drive returns, though not new to investors in the sector, means that they should expect more volatility in global technology looking ahead.

Indeed, with global technology shares trading at nearly 24x trailing earnings, they sit near the upper end of the 22-25x range that has constrained the sector during previous economic expansions since the Tech Bubble.

Should multiples, already off their 2018 highs, contract further to the low end of the range at 22x, it would suggest returns for the year would remain positive while signalling that a decline of 4% from current levels might lie ahead.

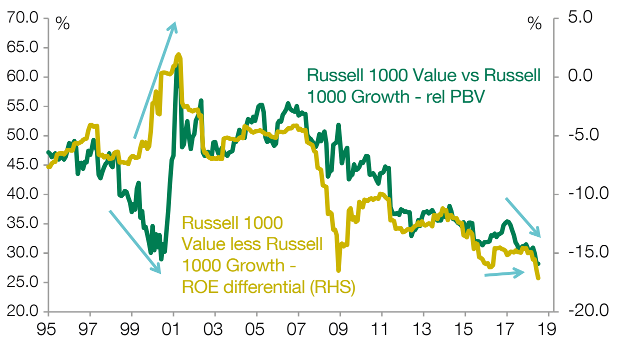
If instead multiples hold near current levels, investors might envisage the 22% earnings growth expected for 2018 supporting an additional 4-5% in total returns looking towards the year end. More optimistically, were PEs in the sector to return to the 25x that has marked the high for the year, investors might well see an additional 11% in total returns beyond the 12% returns achieved through end-July.

Opportunities remain attractive for Tech

Although investors should expect absolute returns to become more volatile, the relative attractiveness of technology remains largely intact.

Technology shares act as key components among 'growth' stocks in the United States, despite the strong outperformance of US growth (+10.4%) versus US value stocks (+2.2%) through end-July. In fact, US growth stocks led by technology shares are showing no warning signs of any fundamental divergences that preceded the Tech Bubble of the early-2000s.

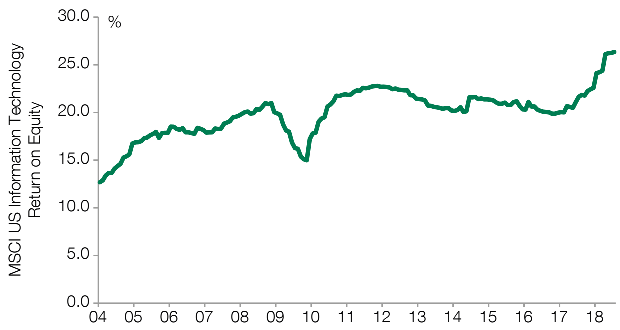
Unlike 1999-2000 no signs of a bubble in US Tech/ Growth stocks vs. US Value Stocks



Source(s): Russell Investments and Bloomberg Finance L.P.

Indeed, the ongoing improvement in returns on equity in US technology shares is a key reason for the fundamental strength of the rally over the past year. Returns on equity from the sector have risen from a 15-20% range across the cycle prior to 2008 to a now more consistent 20% to 25% (and above) return as buybacks and payout ratios have risen significantly since 2012.

US Technology Returns on Equity have re-rated



Source(s): MSCI and Bloomberg Finance L.P.

Tax cuts in the US in 2018 have undoubtedly spurred the recent re-rating in the technology sector ROE. With payout ratios among US tech firms at a modest 20%, the capability for them to continue to use share buybacks and rising dividends to underpin earnings and returns appears significant.

So, despite this shift in regime – away from PE expansion contributing to returns – the improving return profile of the technology sector compared to the broader market, especially in the US suggests the sector will remain attractive for stock pickers. They will need to be able to navigate away from companies exposed to multiple contraction and instead focus on sustainable earnings with stable valuation outlooks.

As a result, investors should pivot from passive, index-oriented technology exposure and instead seek to benefit from active management opportunities that should arise in the space in light of the switch in regimes the sector has experienced in 2018.

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August 2018

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