FRONTIER ADVISORS

Observations on Listed Equities

North American Research June 2014

Frontier Advisors Pty Ltd

International Research Issue 08

Frontier regularly conducts international research trips to observe and understand more about international trends, and to meet and evaluate first-hand a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high level assessment on the key areas and observations unearthed during this research venture. We would be pleased to meet with you in person to provide further detail on these observations.

Our research team

William Leong and Sarkis Tepeli of our Equities Research team travelled to North America in late May 2014, meeting with 30 fund managers in Montreal, Boston, Connecticut, New York, Salt Lake City and Los Angeles.

The meetings covered global (value, growth, thematic, quantitative), emerging market and global small caps equities. While much of our time was spent discussing and assessing the capabilities of the managers themselves, these meetings also allowed us to discuss the market environment for equity investing and developments in the Information Technology sector, which has been quite topical leading up to and during our visit in North America.

William Leong

Sarkis Tepeli

Technology

Where have we come from and where are we now?

Most managers acknowledged we are in the third era of evolution with respect to the Technology sector. The eras are broadly defined as follows: (1) central mainframe processing; (2) de-centralised/distributed computing power via the personal computer; and (3) cloud computing, mobile devices and internet/social media.

A key point of difference with many companies in the third generation is that they are typically asset light businesses and do not have legacy assets (especially social media companies). In fact, a number of managers noted that the new era in Technology was reducing the benefits that have traditionally accrued from scale as new business models were increasingly asset light.

For example, a new company that traditionally had to spend a large amount of money on technology infrastructure to compete with an established firm can now lease the use of servers and other mission critical application from firms such as Amazon (via Amazon Web Services) for a relatively small cost.

There was consensus among managers that the third era in technology had three broad trends: mobility; social; and data (volume growth, bandwidth and analytics). We note that venture capital managers have been assessing these trends for a number of years already.

An interesting observation that was raised by a few managers is that the success of internet/social media companies hinged on their ability to collect and monetise consumer data, by selling this information and that many were making progress in this regard.

A consistent theme from our meetings is that technology will become increasingly important as an enabler for companies to improve the productivity of capital (workforce, machinery and equipment). Advancements in technology coupled with heightened connectivity have made new ideas, processes and designs more readily available.

As a result, many companies can now effectively go global when desired without the need to establish a business in the domestic market first before expanding nationally or internationally.

Opportunities and risks

The ubiquitous nature of technology and the heightened level of connectivity have also created opportunities for other parts of the sector. An obvious example has been the increasing need for enhanced security options for enterprise and the need to deal with the exponential growth of data.

While most managers were aware of the potential opportunities in the industry, far fewer had a good grasp, in our opinion, of the risks that disruptive technologies had on existing companies or business models across all sectors of the economy.

The company WhatsApp (a free messaging service) was used to illustrate how its business model has effectively undermined the texting business for most global telecommunication companies, and this firm did not exist five years ago.

We believe managers that do not fully appreciate the risks of disruptive technologies and do not include this in their fundamental analysis will increasingly invest in “value traps” or misinterpret structural changes as transitory factors.

© Frontier Advisors

Valuations – Where are the opportunities?

Leading up to March 2014, many internet/social media companies had performed very strongly relative to other Technology companies. Despite the strong pullback of these stocks since March 2014, many managers still believed that these stocks remain overpriced, with a high growth premium embedded in current valuations.

Notwithstanding the strong relative performance of some parts of the Technology sector, as a whole it is trading at around the median valuation of the MSCI All Country World Index at a price to equity ratio of 17 times forward 12 month earnings. This indicates that stock selection will play an outsized role in generating alpha over the coming year.

There was general agreement that a bifurcation of valuations in the Technology sector was evident. At one extreme (expensive end) are the valuations for cloud computing/social media companies, such as Facebook, Tencent, Twitter, Salesforce.com etc, and at the other extreme (cheap end) are what many refer to as legacy technology companies, such as Microsoft, Samsung, HP, IBM etc. The legacy technology companies are usually characterised as being enterprise based with capital heavy business models.

A number of managers (particularly managers with a Value style) noted the largest opportunity is in asset heavy businesses as the market generally has a negative perception of these companies believing these firms cannot use the new technologies to their advantage.

However, other investors (particularly those with a Growth style) have strong conviction that these "expensive" cloud computing/social media stocks have new and still untested business models that could potentially generate extraordinarily high growth rates if successful. Certainly, venture capital managers have already benefitted from bringing these companies to the listed markets.

Implications for style investing

The bifurcation of the Technology sector is providing a deep opportunity set for active management. In particular, many Value managers that we met saw the current environment as a great time to set up portfolios for strong excess returns from the Technology sector in the future.

The Technology sector is historically an area where, on average, Value managers have struggled to add value. This can be explained by the fact that trends in the Technology sector develop very quickly when compared to many other sectors, which gives managers less time to respond and adjust their analysis and expectations.

Advancements in technology can also make it more difficult to determine whether sub-industry headwinds are transitory / cyclical as opposed to structural. This increases the probability of falling into value traps – a serious concern for Value managers investing in Technology stocks.

The Growth managers that we met with were also excited by the opportunities in the Technology sector. While some are believers in the much hyped social media and cloud firms, other growth managers are focused on legacy companies with above average earnings growth, such as Amazon, Cisco, Oracle etc.

Based on the large opportunity set in the Technology sector, it is not surprising to see both Value and Growth managers having large overweight allocations to this sector and, at times, ownership of the same stocks (eg. Google is seen in both Value and Growth portfolios).

© Frontier Advisors

Technology continued

It was clear from our meetings that the level of analysis performed on technology companies (and internal expertise) varied significantly from manager to manager.

The Managers that struggled in this sector either misjudged industry trends or were too slow to react.

In contrast, Managers that were more successful in this sector were able to identify structural changes earlier and were able to gain exposure to trends via pure-play and indirect means (via second or third derivatives of a trend).

Technology conclusions

Our North American research trip has highlighted there are many exciting developments taking place within the Information Technology sector, which have the potential to create global leaders, challenge and disrupt existing businesses and business models. This creates opportunities and risks for all managers. We believe managers that are best placed to win in the Technology sector are ones that are best able to distinguish between transitory/cyclical versus structural changes. It will also be interesting to see if Technology stock valuation starts to become an increasingly important factor in manager returns.

 © Frontier Advisors

Recent pick-up in M&A activity

During the research trip, we observed a meaningful pick-up in US corporate activity, via a number of large M&A deals announced (Pfizer and AstraZeneca; Comcast and Time Warner Cable; and Apple and Beat Electronics). This was a key talking point. Many managers pointed to strong balance sheets, abundant and cheap credit financing and improving business confidence as the catalyst for the pick-up in M&A activity.

The rise in corporate M&A has raised volumes to a level comparable to 2005-2007. A few managers noted that companies' increasing desire to spend on acquiring firms is typical at the latter stages of a bull market.

Most managers noted that the increase in M&A activity is moderately supportive of the equity market.

Observations on the capex cycle

Many managers acknowledged that most companies, outside of the Resource sector, have not spent much of their windfall from high margins and low interest rates, on capital expenditure (capex) since the financial crisis. There were divergent views on what the current environment meant for the capex cycle.

One group of managers believed that we would start to see a strong capex cycle. These managers noted that many corporates had delayed capex spending over the last five years as the market was penalising this activity, and as investors had a preference for dividends and buybacks. This has started to turn based on recent data points and will be further boosted by improvements in business confidence. Interestingly, a number of managers believed that the Technology sector, in particular, would be a key beneficiary of the deferred capex as we are coming to the next technology upgrade cycle.

On the flipside, other managers noted that there was not conclusive evidence to suggest that the capex spending was starting to pick up, and that capex usually hovered around long-term GDP levels.

© Frontier Advisors

Back to the future – reward for stock selection

Within developed market equities, managers noted market conditions had normalised over the past year and that stock specific attributes were driving returns, which is producing a more favourable environment for active management.

The average pairwise correlation of stock returns (based on six month daily data) had fallen significantly over the past year and is around average levels (for the period from July 1988 to December 2013).

This indicates the opportunity set for active management and the ability to add excess returns is at historical averages, but significantly more attractive than most periods over the last three years on this measure (as stocks are no longer moving together as much as the most recent period).

In contrast, emerging market equities have faced greater thematic and macro risks than developed markets over the past year, which has been a headwind for managers that employ a bottom-up stock selection approach. Emerging markets managers were optimistic that macro headwinds would dissipate and that company fundamentals would be rewarded going forward.

While it has not been a strong style driven market, the Value approach has benefitted from a slight tailwind as investor confidence and the "expensive defensive (sectors)" phenomena have pushed investors further out on the risk spectrum, which typically overlaps with Value portfolios.

Against a backdrop of a more favourable environment for active management, and as we enter the fifth year of an economic recovery, we expect the ability to generate good absolute and relative returns will be increasingly predicated on the appropriate structuring of global equity portfolios and strong manager skill.

 © Frontier Advisors

Level 16, 222 Exhibition Street

Melbourne, Victoria 3000

Tel: +61 3 8648 4300

www.frontieradvisors.com.au

@frontier_adv

About Frontier Advisors: Frontier Advisors is one of Australia's leading asset consultants. We offer a wide range of services and solutions to some of the nation's largest institutional investors including superannuation funds, government/sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis, and general investment consulting advice. With around $200 billion in funds under advice we have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients. At Frontier, we're on your side.

Frontier does not warrant the accuracy of any information or projections in this paper and does not undertake to publish any new information that may become available. Investors should seek individual advice prior to taking action on any of the issues raised in this paper. While this information is believed to be reliable, no responsibility for errors or omissions is accepted by Frontier or any director or employee of the company. Frontier Advisors Pty Ltd ABN 21 074 287 406. AFS Licence No. 241266.