COVERING Q3 2018

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FUND COMMENTARY
THREADNEEDLE (LUX) GLOBAL TECHNOLOGY FUND

Paul Wick
Fund Manager

Summary

- Global technology stocks performed well in the third quarter.
- Gross of fees, the fund underperformed its index.
- Stock selection in software contributed positively, as did an underweight position and stock selection in internet software & services.
- Positioning and security selection in the semiconductor and hardware industries detracted.

Market Background

US equities gained ground in the third quarter, based on the 7.4% return of the Russell 1000 Index. As was the case in the prior three months, the market was boosted by the dual tailwinds of robust economic growth and better-than-expected corporate earnings. Together, these factors helped stocks continue grinding higher despite concerns about protectionist US trade policy and continued interest rate increases by the Federal Reserve. The Fed raised rates by a quarter point on September 26 — its third such increase in 2018.

The relative strength of growth stocks proved to be another persistent trend that carried into the third quarter, with the Russell 1000 Growth Index gaining 9.2% — outpacing the 5.7% return of the Russell 1000 Value Index. The one-year returns of the two indices stood at 26.3% and 9.4%, respectively, as of 30 September. Investors continued to favour faster-growing companies, particularly those with above-average economic sensitivity, leading to outperformance in sectors such as information technology, consumer discretionary and industrials. Conversely, the types of slower-growing, defensive stocks typically found in the value category trailed the broader market. Dividend stocks were especially notable laggards at a time of rising yields for short-term, fixed-income assets.

In a reversal of the trend that characterised the first half of the year, small-cap stocks lagged their large-cap peers with a return of 3.6% (as measured by the Russell 2000 Index). Smaller companies had performed well in the prior two quarters based on expectations that their domestic focus would provide protection against the effects of a potential trade war between the US and China. Investors appeared to grow less confident in this thesis as the third quarter progressed, leading to weaker relative performance for small caps in September.

Within the benchmark MSCI World Information Technology Index, returns from the hardware, software, communications equipment and IT services industries all exceeded the benchmark return, while the internet software & services and semiconductor industries lagged for the quarter.

Performance

The Threadneedle (Lux) Global Technology Fund underperformed the benchmark MSCI World Information Technology Index during the third quarter of 2018. Stock selection in the software industry made a positive contribution to returns over the quarter, as did an underweight position and stock selection in the internet software & services industry. However, positioning and security selection in the semiconductor and hardware industries detracted.

The portfolio maintains a large relative overweight position in the semiconductor and semi-cap equipment industry, which has negatively impacted recent performance on macro-concerns ranging from global trade tensions with China to concerns of a cyclical peak in semiconductor fundamentals. An additional headwind has been the broader market favouring growth equities over value equities and placing a greater emphasis on companies with increasing revenue growth, large total addressable markets and rising subscribers; by contrast, companies with solid fundamentals and attractive valuations have not been rewarded. The technology team's investment philosophy of "growth at a reasonable price" and balancing projected growth with current valuations has kept the fund away from some of the higher growth momentum names that have performed well this year.

The investment team retains a positive view on the semiconductor industry and believes the market fears of a cyclical peak that the industry has historically exhibited are exaggerated for the following reasons:

- Industry consolidation over the last five years has resulted in fewer semiconductor companies, many of which are more focused on profitability than gaining market share from each other. This discipline with regard to managing the manufacturing process should dampen the cyclicality the industry has experienced in the past.
- Increased growth in semiconductor content across a wider range of end markets should diversify demand. In addition to PCs and mobile phones that have historically been the primary drivers of demand, an increasing amount of semiconductor content is required for servers in cloud data centres, internet of things (IOT) applications like surveillance cameras, Amazon Echo-like personal assistants, game consoles, crypto currency mining rigs, automobiles, artificial intelligence applications, and digital TVs.
- The slowing of Moore's Law has resulted in an increased capital intensity required to meet market demand for increased processing power and speed. Semiconductors are becoming more complex, which is a positive for the wafer fab equipment companies held in the portfolio.
- Semiconductor and semi-cap equipment companies are trading at low valuations, have attractive free cashflow yields, high operating margins and strong balance sheets.

Among positive contributors, the portfolio benefitted on a relative basis from an underweight position in the internet software & services industry, which underperformed the benchmark during the quarter. An underweight position to Facebook was advantageous, after the company lost a record $119bn of value in one day on quarterly earnings that missed revenue expectations and a reduction in forward guidance. Investors were also concerned on slowing user growth in key markets and the impact on future ad revenue as users are given more power to keep their data private. Not having exposure to other social media companies, such as Twitter, which also warned of slower ad revenue growth and a decline in users, benefited relative returns.

Within software, a holding in security software business Fortinet contributed to returns after the firm raised forward guidance following quarterly earnings that beat top-line and bottom-line expectations. A product-refresh cycle drove revenue growth to double digits after a streak of single-digit growth. A position in speech-recognition software company Nuance Communications contributed to returns after management reported better-than-expected earnings and reaffirmed guidance. The stock also got a boost from Nuance's board authorising an incremental share repurchase program and a reduction in the company's debt load.

The portfolio's overweight to the semiconductor industry was the largest detractor from performance in the quarter. Semi-cap equipment company Lam Research reported quarterly earnings which beat analysts' revenue and earnings expectations. While forward guidance was below expectations, analysts appeared to draw comfort from the reduction being largely down to a pushout of DRAM-related spending at Samsung. Several analysts said that valuations were very attractive given the company's record of delivering impressive compound annual growth rates for revenues and free cashflow. Lam Research seemed to agree the stock was undervalued, as evidenced by management's decision to increase share buy-backs to $1.3bn in the fourth quarter from $80m in the third quarter.

Later in the third quarter, a series of analysts downgraded the semiconductor industry, saying that memory markets appeared to have weakened in recent weeks and that slowing demand was causing increased inventories and pricing pressures. These reports had a negative impact on other portfolio holdings such as Micron, Applied Materials and Marvell Technology, and cast a cloud over the wider industry. Prior to quarter end, Micron reported solid earnings that beat analyst estimates but issued muted forward guidance on gross margins, citing Chinese tariffs.

Within hardware, an underweight to Apple, which comprises a 13% weighting in the index, detracted from relative returns for the period. Apple announced better-than-expected results driven by continued strength in services and average selling prices for iPhones that topped forecasts. The company also got a boost from its annual product launch event, where next generation iPhones and a new Apple Watch were introduced. The stock price also continues to benefit from the enormous share repurchase program put in place by the company. The portfolio has a significant position in Apple and to other companies in Apple's product supply chain, but holds an underweight relative to the index as a means to diversify risk.

Activity

During the quarter, we took advantage of stock-price weakness to add to semiconductor names including Marvell. We also exited Alibaba, GreenSky, JD.com and Cavium.

Outlook

The fundamental backdrop for the technology sector has remained healthy all year, buoyed by many of the same positive trends evident in 2017: the move to cloud-based software from on-premises software, robust spending on cloud data centres (Google and Facebook are spending 30-50% more this year), rising electronic content in autos and industrial products, faster network speeds, social media and videogames displacing television viewing and newspapers, e-commerce momentum continuing, and mobile apps conquering the world. Further helping matters, tax reform is enabling a broad swath of US companies to become much more aggressive in capital return to shareholders.

As always, we continue to adhere to our disciplined investment process, which relies on deep fundamental analysis to identify those companies that we believe have the best growth prospects, trade at attractive valuations and that have the potential to deliver solid investment returns over time.