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Previously Investec Asset Management

Finding growth beyond the big tech FAANG stocks

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The fast view

- In our view, bottom-up stock selection can mitigate elevated levels of volatility, specifically by investing in high-quality businesses with robust business models that can withstand a changing political and economic landscape.
- The big tech FAANG stocks may face increased regulation. As discerning stock pickers, we choose to focus on structural growth opportunities at reasonable valuations.
- Digital payments and cloud computing are some of the exciting structural trends in which we have invested.
- Global equity remains a key driver of asset class returns for our flagship Quality SA multi-asset funds, namely the Ninety One Cautious Managed and Ninety One Opportunity Funds.

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Investors have faced ongoing volatility in 2020. Besides the market shocks due to the pandemic and subsequent economic lockdowns, uncertainty around the outcome of the US election has also meant a bumpy ride for investors more recently. Looking beyond the US election, we have reached a difficult point in the market and economic cycle where the absence of new liquidity stimulus has focused attention on profits over the near term and their recovery path. We have remained focused on maintaining a valuation discipline, investing for resilient growth and trying to avoid undiscounted regulatory risk. The unpredictability of markets has taught us not to worry so much about who wins on the political front because you might get the stock market's reaction wrong, even if you accurately forecast the outcome. So for us, it is important to ensure that any investment in a business is based on strong fundamentals, and not an attempt to lock in potential benefits associated with a binary outcome such as the US election.

A brave new world – some of the leaders and laggards that have emerged

We have witnessed a huge diversion in fortunes within the global equity market this year. The gap between the winners and losers is widening.

On the one hand, we have seen euphoria as markets have bid up the share prices of thematic stocks like Zoom and Tesla. The former has certainly become a household name for corporates. Despite the prominence of Zoom, we believe Microsoft Teams is a better product. It is tied into a Microsoft ecosystem, making its competitive advantage stronger. Zoom will find it difficult to maintain or grow its $132bn market valuation.

Tesla produces desirable vehicles based on the foundation of proprietary environmentally-friendly battery technology. Markets have valued the environmental, social and governance (ESG) sustainability characteristics of the business advantage highly but focused far less on the financial fundamentals. By valuing Tesla at $364bn, investors have signalled that the business is worth more than the entire global listed automobile sector!

We have embraced digitally advantaged businesses as we believe investors need to think carefully about what has changed structurally. It is important to consider which companies will be able to recover and exceed levels of profitability that existed before the fallout from the COVID-19 crisis. In simple terms, any business without a digital platform that is also exposed to fragile or shrinking markets is going to find it extremely difficult to recover from weak price levels.

On the other hand, the lagging sectors in the markets make sense to us. This is especially relevant when thinking about cheap assets in unloved sectors. It is hard to see how the world moves back to linear television in a world of digital streaming. Can we conceive how we move back to a fully paid/subscription-only-based print media model, having embraced free online editorial content and social media? In our view, it is important to stay with those businesses that have strong competitive advantages and a distinct growth path.

Some of the most challenged business models can be found in real estate. Land will always have value, but the wealth destruction caused by the plunge in listed property stocks globally, suggests that highly leveraged models need to change; office space will need to be reconfigured and retail channels will have to diversify. The insolvency of Intu properties, owner of several large malls and centres in the UK, epitomises this point.

Big tech has been a massive outperformer this year

Technology shares both in China and the US have delivered spectacular returns in 2020. Apple, which has a market capitalisation of close to $2 trillion, is up almost 58% since the beginning of the year, while Amazon, with a market capitalisation of $1.6 trillion, has seen its share price surge more than 70% (as at the end of September 2020). In this environment, there is a huge requirement for topline growth, and analogies have been drawn to the year 2000, when technology outperformance over wider indices was last so stark.

Many of the big tech companies have encountered increasing scrutiny, with Facebook, Amazon, Apple and Google all facing questions in front of the US congress over the course of the northern hemisphere summer. A point of focus was their increasing dominance over their respective value chains, and the harm potentially anti-competitive practices could have on the consumers these companies serve. As global equity managers, we closely follow the fortunes of these so-called FAANG stocks – Facebook, Amazon, Apple, Netflix and Alphabet (Google). After all, these are some of the most profitable businesses in the world. We do not think these shares offer bubble-like valuations in aggregate but would caution investors to look for clues to factors which will either limit their growth or challenge their profitability.

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However, we choose to focus on structural sustainable growth opportunities at reasonable valuations. It is interesting to note that the FAANG stocks account for one-fifth of the entire S&P 500 Index, but as discerning stock pickers, we have found many other compelling investments within the global equity universe. In these cases, we can underwrite business models with less risk.

Structural growth at a reasonable price – not growth at any price

We envisage an increasingly difficult regulatory environment for a number of these supersized tech businesses. Instead, we have allocated the Ninety One Global Franchise portfolio's tech exposure to capitalise on some of the most exciting structural trends to develop within the sector over the past decade. Most notably, the rise of digital payments and cloud computing, which we access via our positions in companies such as Microsoft, Visa, Intuit and Autodesk. Microsoft and Visa have both already managed the regulatory onslaught and have refined their business models.

Figure 1: Ninety One Global Franchise Fund – top ten holdings

Name	Weight
Visa (Visa)	8.6%
Microsoft (Windows 10, Office365, Skype, Xbox One, Surface)	6.7%
Moody's (Moody's Investors Service, Moody's Analytics)	6.2%
Verisign (.com, .net)	4.9%
Booking (Booking.com, Kayak.com, Rentalcars.com)	4.5%
Roche Holding (Rituxan, Avastin, Herceptin)	4.3%
ASML (EUV lithography, DUV lithography)	4.3%
Nestlé (Gerber, Nescafé, Maggi, Nespresso, Purina)	4.2%
Intuit (QuickBooks, TurboTax, ProConnect)	3.7%
Johnson & Johnson (Sudafed, Listerine, Calpol, Clean & Clear)	3.6%
A concentrated portfolio	**51.0%**

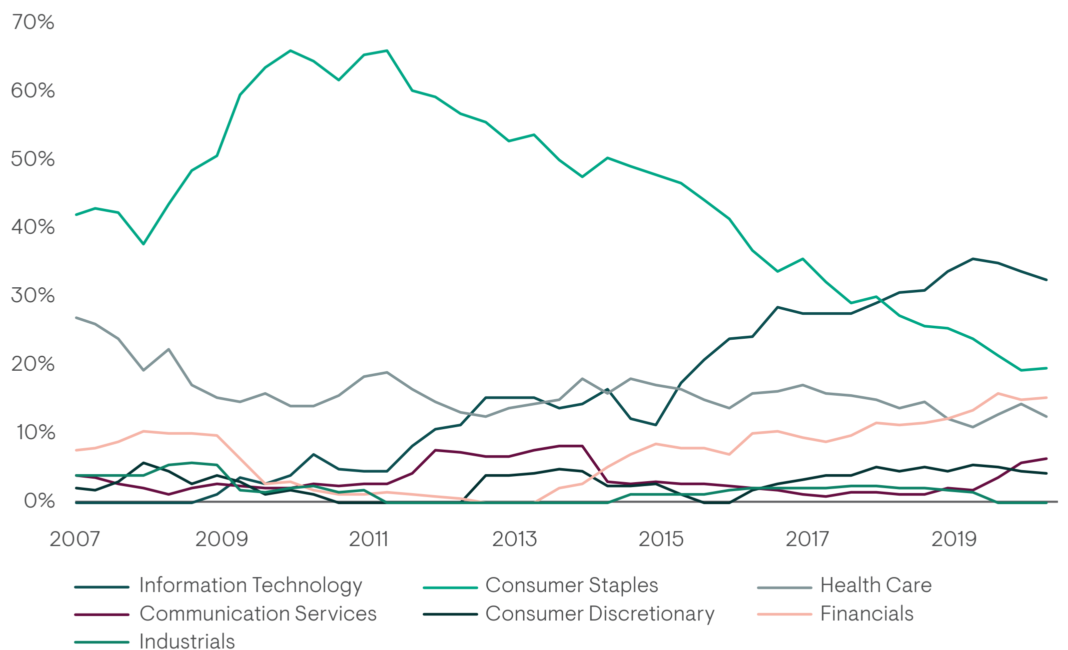
This is not a buy, sell or hold recommendation for any particular security. The portfolio may change significantly over a short period of time. Source: FactSet, 30 September 2020.

Another interesting position that we hold is in ASML. While this business shares some characteristics with mega-cap tech names in the US (supernormal earnings growth in the coming years versus the broad economy), there are important differences. We have a great deal of conviction in the revenue drivers underpinning that earnings growth. ASML's revenue growth will be driven by a significant product development cycle that is underway (the adoption of EUV lithography within the semiconductor industry). Another differentiating factor is that ASML is in a natural monopoly position, underpinned by technological dominance. This is quite different to some of the platforms and offerings which rely on consumer preferences and tastes.

Besides structural growth drivers in the technology space, we own what we call "counter-correlated businesses" that have also benefited from the drive towards home entertainment and remote working, sparked by COVID-19. Online gaming company, EA Sports, is one such company we own, whose business fundamentals have improved since the onset of the pandemic.

Financial data and software company, FactSet is another good example. Asset management businesses have directed a lot of expenditure towards technology – not just Zoom and video-conferencing facilities – but to data providers such as FactSet. The need for people to work from home with easy access to data, means more licences are sold, increasing the revenue of such companies.

Figure 2: Ninety One Global Franchise Fund – sector breakdown since inception



Source: Ninety One and FactSet, 30 September 2020.

> Our exposure to the information technology sector has grown over time due to the structural growth trends on offer, but we retain a material holding in more defensive areas of the market.

While our exposure to the information technology sector has grown over time due to the structural growth trends on offer, we retain a material holding in more defensive areas of the market. We recognise the need to have balance in our equity portfolios. Factors such as the COVID-19 environment, economic slowdown and government policy action make very little difference to the fundamentals of these companies. Nestlé is one such a portfolio holding. Essentially, it is a recession-proof business, with strong consumer brands and an extensive distribution network. Roche is another good example. People who are on chronic medication need it – irrespective of economic circumstances. So, those business are attractive diversifiers in our Global Franchise portfolio.

In conclusion, we see technology shares providing a key role in our Quality portfolios going forward. However, we are mindful of risks and seek balance through other equity holdings, and where appropriate, further diversification in our multi-asset portfolios.

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