Portfolio Manager Q & A

Looking to Tech to Fill Your Growth Needs

RCM

Allianz Global Investors

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Q: What's driving the recent increase in volatility for technology stocks?

A: We think there are both market reasons and fundamental reasons for the volatility. When we go to conferences now, about two-thirds of the people in the room are with hedge funds. They're active and they're in the market every day. That inevitability increases the volatility in the sector and in individual stocks. I think that the fundamental concerns are about the economy in '07. We're in the third year of a market that's been strong and this is typically a time when people worry about being able to continue the economy's growth.

Q: Do you have a view of which way the economy will go?

A: I'm optimistic. I think either the market will break to the upside or the economy's going to be weaker and the Fed is going to start reducing rates, and at that point the market is likely to take off.

Q: How much of the tech market is driven by consumers and how much by business?

A: The exciting parts of technology have been on the consumer side, and the more consumer-centered your company has been the better you've done in the last few years. There have been some exciting transitions in technology, especially with the consumer, whether it's digital music or growth in the Internet or the change toward LCD and digital TVs it's been a pretty strong consumer-led market. If you've been exposed to that as a semiconductor company or as a technology company, you've done relatively well. On the business side, I think things are flat. Ever since 2000 there's been a mindset of trying to spend as little money as possible on technology and to keep budgets tight, and I don't expect that to change. I see a gradual improvement in the numbers because of the need for building out telecom networks for video, for capital spending by the telecom and cable companies. That's a big part of capital spending. I think there's a big shift in capital spending within companies toward more web-centric spending and less on data centers.

Q: Among the broad market's sectors, technology has underperformed most of the others in recent years. Has the expected return for technology stocks changed?

A: Since the late '90s, investors have been adjusting down expectations for technology-the growth they expect and the valuations they think are reasonable. Even though technology stocks bottomed in 2003, I don't think the growth expectations for technology companies bottomed until recently. So, now, I think we're looking at valuations on tech companies that are like growth stocks, you're paying a little bit more than the market and you're getting quite a bit more growth.

Take IBM as an example. The company is growing at 4 percent or 5 percent annually in sales but it throws off enough cash that it generates 10 percent earnings growth pretty consistently. And it buys back enough of its stock so that shareholders realize this value. You can make the same case for Microsoft and Oracle. The latter has been using cash in a different way to grow their earnings faster; rather than buying their stock back they've been buying companies. The important point of these examples is that the technology sector is attractive in terms of the cash flow it generates. Many of these companies earn margins in the range of 40 percent or higher. That's hard to find anywhere else in the economy.

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Q: Do you think investors went too far in reevaluating technology and that these compelling fundamentals and valuations are the result?

A: Yes, I think the big technology companies are at the point where they can power their stocks up with buy-backs. I don't expect technology stocks to underperform the market anymore because the companies are buying back 3 to 5 percent of their stock each year.

Q: Are there specific new or emerging technologies you're especially bullish about?

A: I'm a big fan of the mobile Internet as a theme. It touches lots of different companies, so it offers a lot of opportunities. Another big theme is the consumer transition to new products. In 2009, analog television signals in the U.S. will turn off. That means everybody will have to own either a digital TV or a converter. Another growth area is in game systems. Whether it's the XBOX 360 or the Wii from Nintendo, you receive more realistic images from the current generation of games and those images fit well with digital TV. And with the Wii you have a whole new genre of games that are casual and fun. They bring a whole new segment of the population to electronic games. You can practice your golf game, bowl or work out with the Wii and you can participate in group activities. The mobile Internet brings a lot of things that people are used to on their PCs into their hands.

Q: How big are the China and India slices of the technology market?

A: Well, in terms of our portfolio, we've got 15 percent or so in Asia, India, Taiwan, Korea, Japan, China and that's rising on a secular basis. As those economies have developed, we've seen the rise of middle classes in India and China. These people are interested in buying products and houses.

The middle class in India and China is as large as the population in the U.S., so it's a very significant incremental growth factor for the world economy.

Q: How do you and your team identify stocks and determine whether they have a place in the portfolio, and how do you determine it's time to sell a stock?

A: First, we look for new ways of doing things or for dramatically lower-cost ways of doings things. Then we look within those themes for companies that are leading those changes. We're looking for global leaders with good management teams, financial characteristics, and franchises that present high barriers to entry. Once we find these companies we have to determine whether those great companies are going to be great stocks. That's a discussion among our team about valuation versus growth rate and other criteria. We look at how much we have to pay for the stock and what we are getting in return in terms of financial characteristics. We don't like to pay, these days, more than 1-1/2 times the growth rate. We find we can buy most companies for about 1 times the growth rate. You know, we've been doing this for over 30 years and that's about as low as we've ever seen the valuation. So, we think it's quite timely. During the late 1990s, we were paying sometimes as much as four times the growth rate.

In selling a position, we might say: OK, we're willing to pay one times the growth rate but if valuation goes to two times the growth rate, then we're going to sell the stock.

Q: What role could a technology sector fund play in an investor's overall portfolio?

A: Technology is a pretty large chunk of the growth stock market. So, for investors who want to invest in growth opportunities, having a technology sector fund could be an important element to a portfolio. It could supplement what you're doing as an investment advisor for your clients. We're trying to create the best growth portion of your portfolio. That's our mission. Over time we aim to outperform our sector and outperform those growth portfolios.