EQUITY

Tech Innovations: Best in Two Decades?

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Despite a jittery start to the year, by mid-March the US technology sector had resumed its position as an outperformer versus the overall US equity market. JP Scandalios, vice president, Franklin Equity Group, attributes the sector's shaky spell to global economic worries and general market jitters, not sector-specific issues. He reports that technological innovations currently on the horizon are the most promising he's seen in more than two decades, and while global demand for IT products cannot be described as robust overall, he sees areas of strength that he believes will thrive even if global economic growth remains subdued.

The technology sector prides itself on its dynamic advances, but one tech tenet has remained constant: Companies must think outside the box to become successful. As tech-trend watchers, we see this phenomenon every day. Start-up or emerging companies can't take a "me too" attitude; they have to either find a market where none exists today, or envision a solution to a problem that's not being addressed by the legacy or incumbent providers. We have experienced this in every generation: Many of the previous generation's technology leaders have fallen by the wayside, or have struggled and resorted to acquiring the next generation's innovator. The tech sector continuously reinvents itself, which typically leads to investment opportunities.

The volatility we have seen this year hasn't dampened our outlook for tech companies. In fact, in my 20+ years researching technology stocks I haven't seen a more robust period of innovation than we're experiencing today.

The potential opportunities we see are not only coming from the household names that many market watchers envision when they think of the sector. They're also emerging from companies that have dominated what we might call the less-glamorous segments of the sector—companies that have been performing quite well but aren't subject to as much marketing hype, and thus are not as well-known to the public at large.

An example is an analog semiconductor company that designs and manufactures semiconductor chips that convert analog signals into digital signals, and vice versa. Analog signals are real-world phenomena (heat, pressure, sound, velocity, flow, vision, etc.), while digital signals are discrete on/off/binary bits that are processed. The ability to convert signals back and forth is increasingly vital in today's digital age. For example, when you "touch" a screen (phone, tablet, notebook, PC, TV, microwave, refrigerator, washing machine, etc.) to give a device a command, the data converter senses the pressure your touch creates, changes it to a digital command, and forwards it on to a processor to be acted upon.

This semiconductor company enjoys a large share of the data converter market, and we have learned that some of its competitors have curtailed further expansion in this area because of the company's dominance of the industry.

Breakthroughs for Everyday Life

The example above illustrates the less well-known areas of the market, but we're finding dynamic innovation and growth across myriad industries in the tech sector. I'm most fascinated by advances that are likely to impact our everyday lives. For example, each iteration and generation of automobiles has brought more sophisticated technology to the century-old task of driving. Sensors embedded in automobiles can record if tire pressure is low, if the engine is running too hot, how fast you are driving and how hard you are braking. By enabling cars to transmit and receive these data, you can have cars that react better than human drivers to dangerous conditions and, for example, engage the brakes to prevent a crash faster than a person could. It was recently announced that this automated braking technology, previously only available on high-end cars, is now slated to be a standard feature. We see opportunities in companies involved in the sensors and software that make these systems work – once integrated into a car, these safety systems are very sticky and can't be removed without significant redesign. Vehicle information in aggregate can also be used for better traffic management when integrated into systems that relay traffic information to other drivers or even to the systems that control traffic lights. These advances are the precursors to a fully driverless car, something we may see in the next five to 10 years.

I'm also intrigued by advancements that allow consumers to have their banking information embedded in their cell phone or on a digital card—allowing us to leave our wallets and credit cards at home. One example is Near Field Communication (NFC) technology, which is a form of contactless communication between devices like smartphones or tablets. Contactless communication allows a user to wave the smartphone over an NFC-compatible device to send information without needing to touch the devices together or go through multiple steps setting up a connection. So I can buy a cup of coffee by waving my phone over an NFC-compatible device, instead of digging in my pocket for cash or a credit card. In addition to the chips that enable NFC, the rise of electronic payments also increases the need for robust encryption to safeguard your personal information.

In the health care sector, there is no shortage of innovation that should drive growth—and change our lives in the process. For example, we've already seen advances in genetic sequencing, which involves decoding a patient's DNA to identify if a person is predisposed

to a certain disease and identify which drugs would be most effective to treat illness, and continuous glucose monitors, which use a tiny sensor placed under the skin to provide diabetics with real-time glucose readings so they can better control their blood sugar levels.

Expectations do tend to run high for technology companies' products—and sometimes for their earnings as well. Early in the year, I think some investors panicked after certain companies delivered disappointing fourth-quarter 2015 results and forward guidance. In my opinion, the market just wasn't prepared for the bad news, and investors indiscriminately sold off the entire sector. Market expectations for fourth quarter 2015 earnings were not necessarily unrealistic, in my view, but I believe investors grew concerned that any negative news would extrapolate throughout the whole sector. Other factors likely contributed to the volatility we saw in the first quarter of 2016, but I believe the selloffs had more to do with fears about macro indicators such as lower oil prices and China's slowing economic growth rate than any issue specific to tech stocks.

However, indiscriminate selling typically gives us an opportunity to add to or initiate new positions in companies we like at bargain prices. In general, we think valuations for the technology sector look reasonable at the moment. While it's one of the most profitable sectors, its forward price-to-earnings (P/E) ratio is only slightly above the overall S&P 500's.[1] And when you compare the sector's P/E ratio relative to its growth rate, it's one of the least expensive sector in the S&P 500.[2]

When searching for what we consider bargains in the tech sector, we think one of our strong suits as investment managers in this space is not only our bottom-up stock selection process, but also the fact that we are located right at the center of technology innovation—within California's Silicon Valley. Our dedicated research team is able to visit these innovative companies and meet with management, right at our doorstep.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Growth stock prices reflect projections of future earnings or revenues, and can, therefore, fall dramatically if the company fails to meet those projections. The technology sector has historically been volatile due to the rapid pace of product change and development within the sector. Technology companies can be small and/or relatively new and unseasoned. Smaller, mid-sized and relatively new or unseasoned companies can be particularly sensitive to changing economic conditions, and their prospects for growth are less certain than those of larger, more established companies.

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1. Source: Bloomberg, as of April 5, 2016. The price-to-earnings ratio, or P/E ratio, is an equity valuation multiple defined as market price per share divided by annual earnings per share. US technology companies are represented by the S&P 500 Information Technology Index. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. Past performance does not guarantee future results.

2. Ibid.

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