



Stuart O'Gorman, 12 December 2008

Making a case for Technology

For any contrarians seeking opportunities within equities, the technology sector offers up a compelling case. Battle-hardened management teams are already well-equipped to survive another downturn, and in a good position to benefit from any market rally.

Companies are bracing themselves for an unpleasant 2009. On a bottom-up basis, the newsflow from all markets, and across most sectors, is going to get worse, and the technology sector is no exception. However, there are some encouraging signs that the credit markets are loosening up in response to the monetary support being offered by most central banks. How sustainable this modest recovery will be depends on just how badly shaken confidence is, which in turn will determine the depth of the recession.

Clients have, in general, taken the view that the smartest asset allocation call in this environment is to be overweight in cash and bonds. This makes sense, but with a few caveats:

1. These markets are now very crowded.
2. Bonds on both sides of the Atlantic could struggle if "Helicopter Ben" Bernanke and Alastair Darling keep issuing Government securities, in a bid to get the medicine working.
3. Minimal exposure to equities will mean a limited participation to any equity rally.

Therefore, abiding by the view that that some diversification is good, we suggest a more balanced portfolio (i.e. one that does not entirely consist of cash,

bonds or gold) is needed. For anyone looking for areas of opportunity within equities, the technology sector offers up a compelling case. The reasons being:

Well funded

Companies within the technology sector have some of the cleanest balance sheets. Most have no net debt on their books and many have stockpiled large sums of cash (take the case of Apple, or Nintendo, the maker of the *Wii* gaming console, both of which have roughly a third of their market capitalisation in cash). Tech companies are managing to avoid the great financial leverage unwind taking place at present.

Spending levels won't go much lower

IT spending has been constrained for a number of years, ever since it suffered the after-effects of the 'tech bubble' at the start of the decade. This means that IT budgets have been kept to a minimum, with companies expected to 'do more with less'. So, while IT budgets will no doubt be cut during the current downturn, the pain will be nothing like that which will be suffered in other areas such as advertising, marketing and travel budgets.

A more streamlined sector

The tech sector is far more competitive and streamlined than it was during the peak of its bubble. Most of the smaller players fell by the wayside, or were acquired by larger rivals. This means that pricing discipline (outside of commodity components) is far greater.

The view on Technology



Savvy management teams

The management teams of most tech companies have become battle-hardened, after surviving a dramatic downturn already. They know what to expect in these circumstances, and have more experience of difficult times than most other sectors from the 'old' economy.

The major players in the technology sector know how to continue making money in a difficult trading environment. After the last bubble burst, Microsoft, Cisco, Intel, Oracle, IBM, SAP, Qualcomm, Hewlett Packard and Nokia all continued to generate profits, despite the collapse in demand.

Flexible business models

For most tech companies, spending will be mainly focused on their salesforce, as well as their research and development teams. This means that many areas of the tech sector have highly variable cost structures, especially over the mid-term.

If demand falls dramatically, it ought to be relatively quick and inexpensive for them to change the business accordingly in order to adjust the new level of demand. It is a lot more difficult for most areas of the "old economy"

with very high fixed costs (factories, distribution etc.) to realign their business models in a short space of time. Likewise, when demand recovers, this flexibility will enable tech companies to react faster than other sectors.

Consistent income streams

Many areas of the tech sector have a high percentage of recurring revenues, a fact that tends to be ignored by the mainstream market, which assumes that tech earnings are all highly cyclical.

Take Oracle as an example. Over 50% of their revenues are derived from highly profitable 'maintenance' business, which is usually the last thing any business switches off before they turn off the lights.

There's no doubt that the short-term outlook for equities remains unclear. However, if you are a contrarian, and are willing to take the view that equities should offer some value over the longer-term, then the technology sector could be a good place to start rebuilding your equity portfolio.

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