

Technology 2012 Outlook



Macroeconomy



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It grieves me greatly to yet again start a technology outlook piece with a view on the macro economy. Sadly, I fear it will be macroeconomic factors that trump stock selection again so we will begin here.

Asset markets of all descriptions have given investors quite a wild ride over the last twelve months. The already poor situation in peripheral Europe continued to deteriorate dramatically with the infection increasingly penetrating into core countries, with contagion effects increasingly visible in the European banking sector. The policy reaction, driven mostly by a desire to save the euro, is violent austerity measures, driving peripheral countries into even deeper recessions. Added to this has been a couple of major environmental catastrophes, an earthquake and tsunami in Japan and major flooding in Thailand which both have had major effects on supply chains, especially technology. Finally, and most worryingly, as we have been predicting for some time, certain emerging markets are starting to see the negative effects of the wave of Western money printing that washed up on their shores. They now face the difficult position of controlling inflation and property bubbles in a challenging macro environment. This, to my mind, is as great a risk to equity market returns next year as European sovereign default – the latter while much more likely, is more fully appreciated by markets. Most investors still seem to think that emerging markets will continue to grow robustly. When bubbles burst it is rare to go from 10% GDP growth down to 8%, so while the chance of an emerging market shock is lower than a European one, it will be a much nastier surprise if it happens.

However, it is not all doom and gloom. The one major bright spot in the world economy is the USA. Here economic news has been getting consistently better, especially in the second half of the year, with signs of stability in the housing market. Corporate balance sheets globally are in a dramatically better position versus the financial crisis. Finally, and most importantly for the short term, global policy makers and central banks are employing increasingly desperate measures to drive up the stock markets rather than fix the fundamental flaws in the global economy. Dramatic attempts at money supply increases are being adopted everywhere, with even the previously stubborn ECB gradually being drawn to it, as long as it is not openly called money printing.

In all of this we are probably telling you little that you do not know already or that has been commented on by better macro economists than us. It is important to point out, however, that macro factors will still, we believe, be the primary driver of absolute returns. On a relative basis we believe that technology offers a good risk/reward trade for investors in most macro-economic outcomes. In the short term, macro news overall is well appreciated by markets, but there may be some disappointment with near-term technology earnings reports that may make relative performance more challenging for the sector. The longer-term structural imbalances of the global economy have still to be addressed, so it is hard to be overtly bullish in the mid to long term, despite very low valuations.

Sector Specifics

Semiconductors

Semis were a mild drag on performance for our technology fund, entirely due to our underweight position in Intel, which has continued to perform despite a weak PC market. We are getting convinced that despite the structural headwinds they face, their dominance of the PC and server markets and resulting pricing power means that it is hard to justify an underweight position and have increased positions accordingly. The fund now finds itself in the unusual position of being very moderately overweight in semiconductors. This is a change from a long standing (and profitable) structural underweighting in the sector. Why? While the industry has dramatically de-rated over time, a number of things have improved structurally in the industry. Firstly, these businesses are simply much better managed than they were historically. Production levels and inventories are now adjusted quickly (and often brutally) to any signs of slowing demand. Cost structures have become a lot more flexible and balance sheets are generally quite strong, with many weaker players having either exited or been acquired. Finally, semiconductors continue to penetrate our everyday lives, with more and more digital devices with more and more silicon content being purchased by consumers and businesses every year. Within the sector, we favour well managed, broadly diversified semiconductors such as Texas Instruments and Analoge devices, and companies tied to growth in connectivity (one of our major themes) such as Samsung, Altera and Sandisk. Our macro worries, especially related to emerging markets, keep us from going aggressively overweight at the moment.

Communications equipment

It has been a very tough year for most communications equipment stocks, with the sector being one of the worst performers in technology in 2011. This has been very broad based. Many of the structurally poorly positioned businesses such as Nokia, Research In Motion and Alcatel have continued to implode, while investors have realised that not even "next generation" or "new cycle" technology company deserves a P/E of over 40x next year in a poor macro economic environment. This sector has been one of the biggest contributors to the attribution of the fund, more by avoiding the disasters than by major successes. Mobile handsets have generally been a disaster area for investors in the sector as Apple and Samsung increasingly suck profits from the rest of the industry. We believe this is likely to continue going forward. While there are some deep value names with interesting assets in the area such as Nokia and RIMM we would prefer to see business trends bottom rather than buying a bad business in the hope of M&A. In addition to Apple and Samsung (which sit outside the Comm Equipment sector) we prefer Qualcomm as the way to play the space due to their increasing share gains and the rapid adoption of smartphones globally. We remain heavily underweight telecom equipment stocks as we remain concerned that capex will be pressured in 2012, especially in Europe and Emerging Markets. In networking we bought back into Cisco as they have finally stopped trying to be a hyper growth company and are starting to go through the painful process of accepting they are a normal company with a good business. We also retain a small position in F5 Networks. We would like to buy other "next generation" networking companies but only when their valuations reflect the fact that they are growth cyclicals rather than growth stocks and are often exposed to a very narrow product area, making them more risky. We are slightly underweight the sector overall.

Internet

While the internet sector overall was one of the better performing sectors in 2011, the strong performance of index heavyweight Google has masked more mixed returns within the sector leading to a neutral impact on the relative performance of the fund. We remain heavily overweight the sector as it remains exposed to most of our preferred themes, especially e-commerce and internet advertising. Names such as Google, Amazon and Priceline continue to benefit from the shift in buying behaviour towards the internet by both consumers and corporate entities. While there will be names that do not succeed due to mis-execution or the entry of a large competitor to their space (generally Amazon or Google) we continue to believe that the secular strength of the story has a large number of drivers – the growth in digital natives, the rapid adoption of data enabled mobile devices such as tablets and smart-phones, the increasing effectiveness of online advertising and finally the simple cost savings that are achievable by going on-line.

Electronic equipment and instruments

We have often referred to this sector as "the gift that keeps on giving" and it earned its title again by being one of the strongest contributors to relative performance in 2011 as we were heavily underweight and it was by far the worst performing sector. It remains dominated by component businesses that generally at best have short term competitive advantages, either product cycle leads or capacity, all of which generally can eventually be

overturned by their rivals. Any "hot" product areas generally attract a flood of capacity and competition leading to dismal returns, such as in LED lighting. In addition many names in this sector also face the problem of being exposed to areas where growth is slowing dramatically such as the LCD TV market and the PC market. Finally management quality is often low, especially for Japanese companies which are a major part of this sector. We have started to pick up a few names in the sector, but unfortunately it is hard to find long term secular stories in the space. We have a large position in Hon Hai, as we believe its scale does at least provide some barrier to entry and is (finally) giving it some pricing power with its largest customer Apple, as they are the only company that can cope with their rampant growth. We remain heavily underweight the sector but are conscious that if we see a dramatically improving macro environment many of the excesses of this sector will be bailed out, at least in the short term. There is also the chance (maybe hope is a better word) that eventually management teams decide to run their businesses in the interest of shareholders. If they do there is potentially a lot of value in many of these names.

IT services

This sector was one of the strongest sectors globally in 2011, but was a mild drag on performance for the fund. The defensive (or at least late cycle) nature of many of the business models was very appealing as investors sought safety from the macro storm. The fund initially was hurt by a lack of exposure to data processors, especially Visa and Mastercard due to regulatory uncertainty. However, once this lifted, positions were built and aided performance from the second quarter onwards. Within traditional IT services stocks it really was a case of the haves and the have-nots. The fund benefitted from being exposed to the correct IT services stocks owning managed global leaders such as Accenture and IBM. These names continued to take share from smaller regional based players who cannot industrialise their processes or provide global solutions. We continue to favour the larger players but have reduced our relative position in all these names due to concerns that they face tough comparisons in 2012, using this to fund some of the increases in certain semiconductor names.

Software

Software was also a mild drag on performance last year. While the fund avoided certain disasters such as Nintendo, this was more than offset by very poor returns in Temenos, the banking software company. Very aggressive accounting had inflated prior year figures, leading us to overestimate the organic growth potential of the company. Problems were compounded by a deepening financial crisis in Europe and Emerging Markets leading us to sell the position. Going forward we are approximately neutral in this sector, reversing a very long term structural overweight in the area. While valuations on many names are attractive we are worried about near term delays in spending decisions that may badly impact stocks, as has already been seen in rather weak results in Oracle, Salesforce, Redhat and Informatica in the last couple of months. We successfully avoided all of these bar Oracle and still believe if spending is restrained Oracle will still be a better name to be exposed to than the more "exciting" names. Again if valuations retreat to more acceptable levels we will look to add to the more aggressive names in the sector, similar to networking names. Many of these companies

are very interesting but all too often are already priced for success. We currently find more pedestrian names such as Intuit, Checkpoint and Microsoft more attractive ways to play the trends in software.

Computer hardware

Hardware stocks contributed modestly to outperformance in the fund last year. Its weighting is dominated by Apple, which makes up approximately 60% of the sector. Apple has been a long-term overweight position for the fund. Sadly we now find ourselves forced to be underweight as it is more than 10% of the benchmark. As we predicted Apple continues to dominate the high end of the smart-phone, laptop, MP3 and tablet markets and is now starting to move its products down the cost curve in smart-phones. Near-term results will continue to be strong and valuations remain ludicrously low. It remains our largest position. Elsewhere we continue to favour storage names such as Network Appliance and EMC. Near term, there may be some risks to estimates as their corporate customers may delay spending, but we think the growth in data means that it will be hard to postpone spending for long. Valuations are also very attractive. Finally we have recently increased positions in Hewlett Packard and Dell due to extremely low valuations. While these are structurally challenged businesses, they are priced for a collapse in fundamentals that we believe is unlikely.

Conclusion and outlook

As we said at the start, absolute returns are going to be dominated by macro factors which are extremely difficult to predict at the moment, especially given the experimental nature of the policy responses i.e. quantitative easing (QE).

There are a lot of exciting things happening in the technology sector at the moment. Consumers are currently spoiled for choice as digital products, especially those with wireless connectivity penetrates our lives on an ever increasing basis. The very nature of how we interact with friends, work and the media is being revolutionised by these devices and new ways of using them such as social networking and tablets. The ever reducing cost of technology means that the addressable market for these products is exploding, especially in Emerging Markets. Corporations, having long viewed technology as a necessary cost that should be controlled as much as possible, are increasingly viewing technology again as a way to help grow sales and reduce other costs within their business. This is being driven by a large number of innovative product cycles, such as virtualisation, mobile working and the ever growing internet to name but a few. We wholeheartedly agree that these trends present opportunities but we must remind investors to be wary of the hype. Too many times have we seen good ideas ruined by capital flocking to "hot" areas, valuations being driven to levels that cannot be justified, investors forgetting that "revolutionary" technology companies are not themselves immune from revolutions and, most commonly, mistaking cyclical strength for secular growth. Many of the "new cycle", "cloud" and "digital revolution" stocks so beloved of technology funds are simply a rather leveraged way to bet on the success of QE, as so many "stock pickers" found to their cost in 2011. Consistent relative returns in technology require a firm understanding of valuation, long-term growth potential and barriers to entry, as well as the technology itself.

For the technology sector we continue to believe that on a relative basis, technology offers an excellent risk/reward option relative to other equities. Some of our main reasons are summarised below:

- 1) Historically low valuations relative to the market;
- 2) Extremely strong balance sheets and cash generation;
- 3) High levels of recurring revenues;
- 4) Flexible business models and cost structures;
- 5) Exciting new product cycles that can spur new markets;
- 6) Continuous cost reduction, making existing products more attractive;
- 7) Dis-intermediation of "old economy" business models by the internet;
- 8) Demographic shift away from digital refugees to digital natives;
- 9) Corporate spending on technology below trend;
- 10) Beta below 1;
- 11) One of the few sectors not invited to the "credit bubble party".

We believe this combination of secular drivers, downside buffers and attractive valuations will help technology outperform in dreadful, bad, mediocre and good markets. Counter-intuitively the environment where technology will struggle on a relative basis is in a rampant bull market. If we have a strong sustained global recovery, companies with bad balance sheets, fixed cost structures etc. will be the strongest performers, and the average technology company does not fit that description. In that (happy) outcome, absolute returns will be very good, but relative will not. We unfortunately view a strong sustainable global macro rebound as the least likely macro outcome so are happy to view technology to equity investors as a way to diversify their portfolio in the long term.

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