Insights from Guinness

GUINNESS ASSET MANAGEMENT

Portfolio Managers

Dr. Ian Mortimer, CFA

Matthew Page, CFA

Global funds from Guinness Asset Management

Guinness Global Innovators Fund

Invests in companies benefiting from innovations in technology, communication, globalisation or innovative management strategies; we believe innovative companies in any industry can improve productivity and grow their profits.

Guinness Global Equity Income Fund

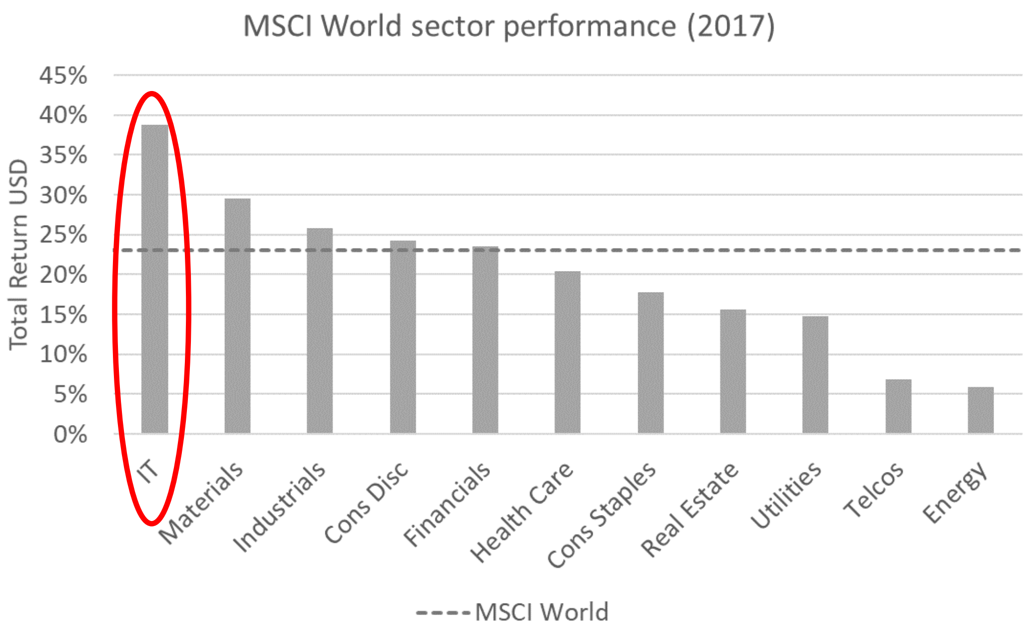
Invests in profitable companies that have generated persistently high return on capital over the last decade; we believe these companies are well placed to pay a sustainable dividend into the future.

The IT sector in 2018 – growth driver, or expensive and overhyped?

Given the Guinness Global Innovators Fund's significant weight in the IT sector and IT's recent strong performance, investors have understandably been asking us whether IT is now overvalued. In this Insight we take a top-down view of what has driven the performance of the IT sector and how valuations and growth rates today compare to history, and look at where we see the most attractive combination of innovation, growth and valuation within the sector.

Whether it was the 'FAANGs'[1], the 'BATs'[2], the internet stocks or the disruptors, 2017 was a strong year for IT companies. The global IT sector was the top-performing sector in 2017 and it generated an impressive total return of 38.74% (USD).

Chart 1



Source: Guinness Asset Management, Bloomberg

[1] Facebook, Amazon, Apple, Netflix, Google

[2] Baidu, Alibaba, Tencent

Whilst 2017 was a particularly strong year for the IT sector, it has also outperformed the MSCI World Index over the last seven years (by 76%) and again it was the best-performing sector over this period.

Chart 2

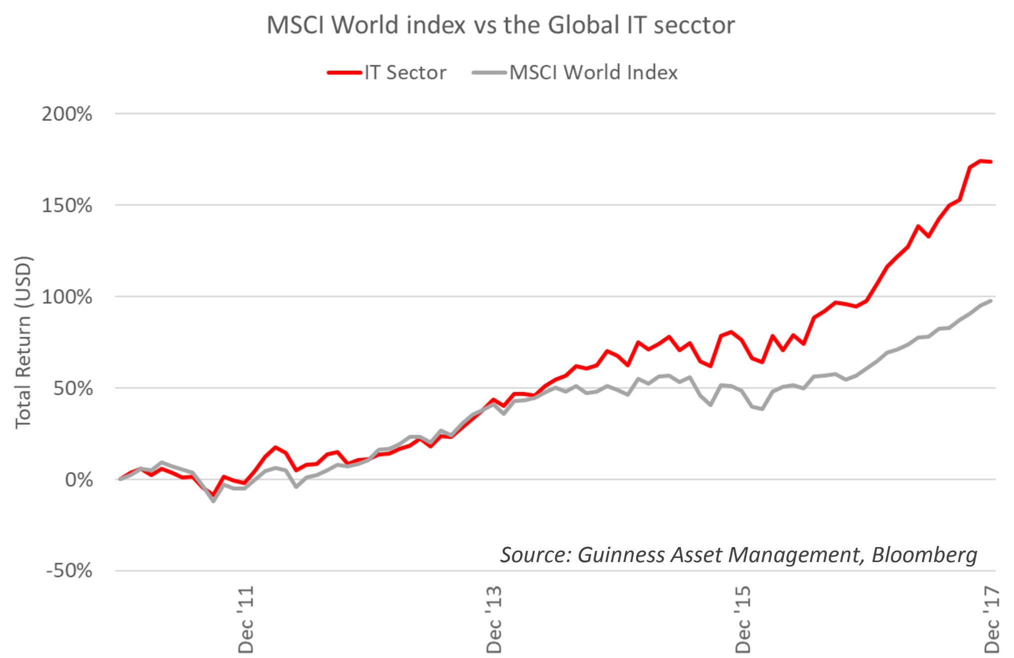
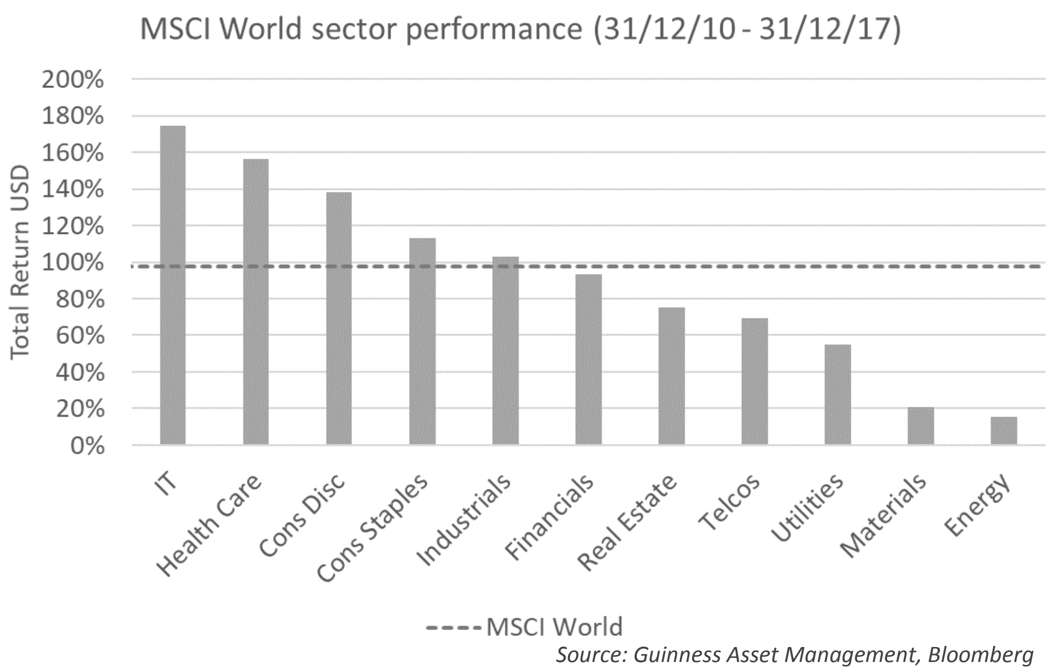


Chart 3



It is interesting to look back at this period and note the outperformance of the more innovative sectors, namely IT, Health Care, Consumer Discretionary and Industrials, in contrast to the generally less innovative sectors, such as Real Estate, Telcos, Utilities, Materials and Energy.

"Innovation distinguishes between a leader and a follower." Steve Jobs

However, given this strong performance by the IT sector over the last year and over the last seven years, should we be worried about IT company valuations?

"Learning and innovation go hand in hand. The arrogance of success is to think that what you did yesterday will be sufficient for tomorrow." William Pollard

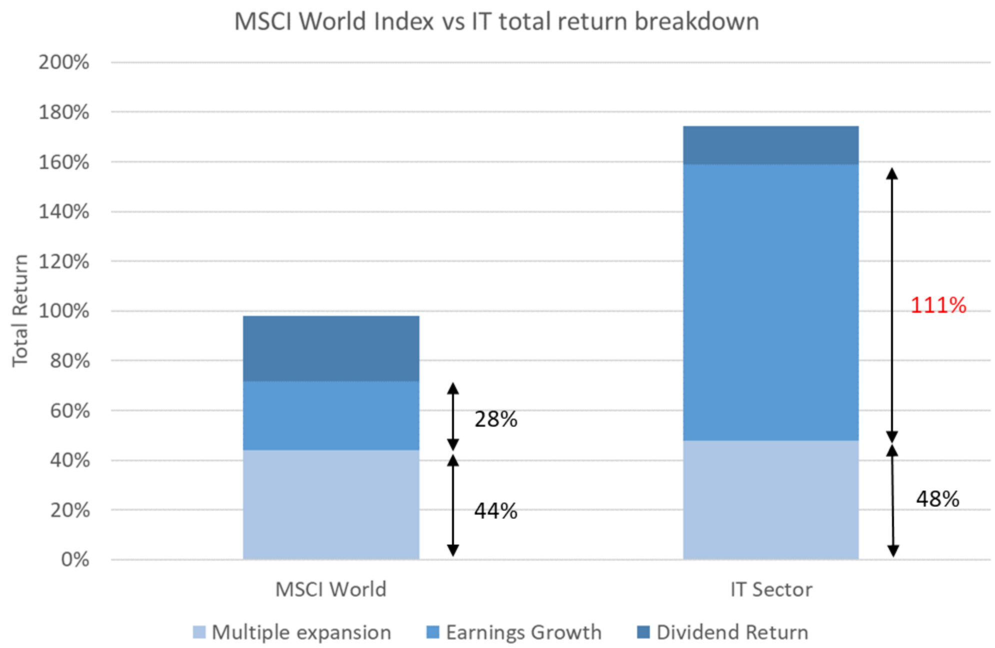
An interesting way to start to answer this question is to look at the performance drivers of the IT sector over the last seven years and compare them to the MSCI World Index.

We can decompose the total return of an equity, sector or index into three parts: first, the return due to a valuation multiple expansion, in this case the price-earnings multiple, secondly the return due to the growth in expected earnings, and thirdly the return due to dividends and their reinvestment.

As you can see in chart 2, when we compare the drivers of the return of the IT sector to those of the MSCI World Index we see that the return due to multiple expansion is very similar for both: 44% for the MSCI World index and 48% for the IT sector.

The main driver of the IT sector outperformance has come from very strong earnings growth. Indeed, earnings forecasts for the IT sector have grown by an impressive 111% over the last seven years, compared to only 28% for the MSCI World Index.

Chart 4

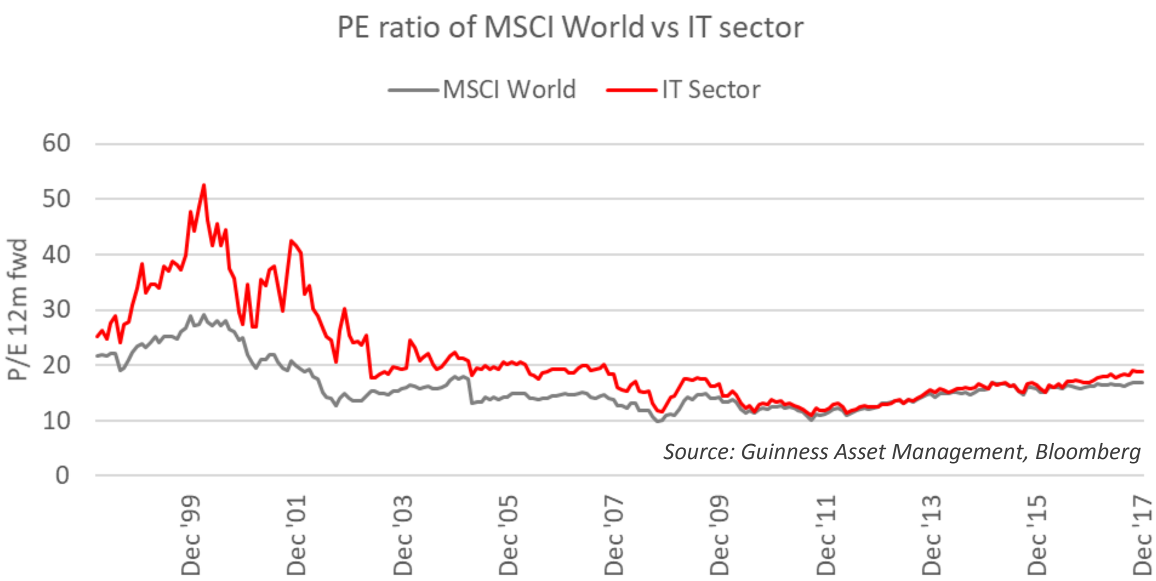


Source: Guinness Asset Management, Bloomberg

Given the multiple expansion in the IT sector has been very similar to that of the MSCI World Index, arguably we should not be overly concerned about the valuation of the IT sector. If anything, should we not be more concerned about the other sectors that are not delivering such impressive earnings growth?

When we look at the valuation of the IT sector and compare it to the MSCI World Index and go back 20 years (as far as we can go back), we can see that the IT sector at the end of 2017 traded at a small premium to the MSCI World. Clearly, we are not in the territory of the excessive valuation of the "dot-com" bubble at the turn of the millennium.

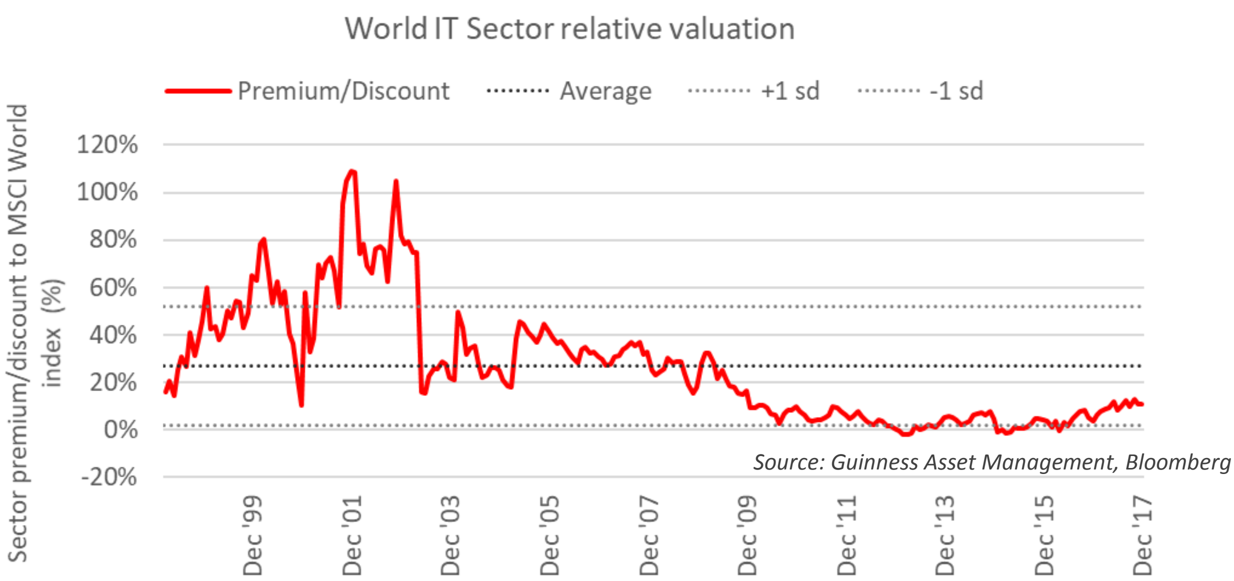
Chart 5



We should expect the IT sector to trade generally at a premium to the broad index given the historic growth rates and potential for future growth in this innovative sector. One might have thought back in 2010 that IT stocks were already expensive relative to the MSCI World Index, but that was not the case, as the chart below shows. In December 2010 the IT sector traded at a 10.0% premium to the MSCI World Index, whereas at the end of 2017 it traded at a 10.4% premium. If we look at the premium or discount that the IT sector has traded at relative to the MSCI World Index over the last 20 years, the premium at the end of 2017 of 10.4% is well below the 20-year average of 27%.

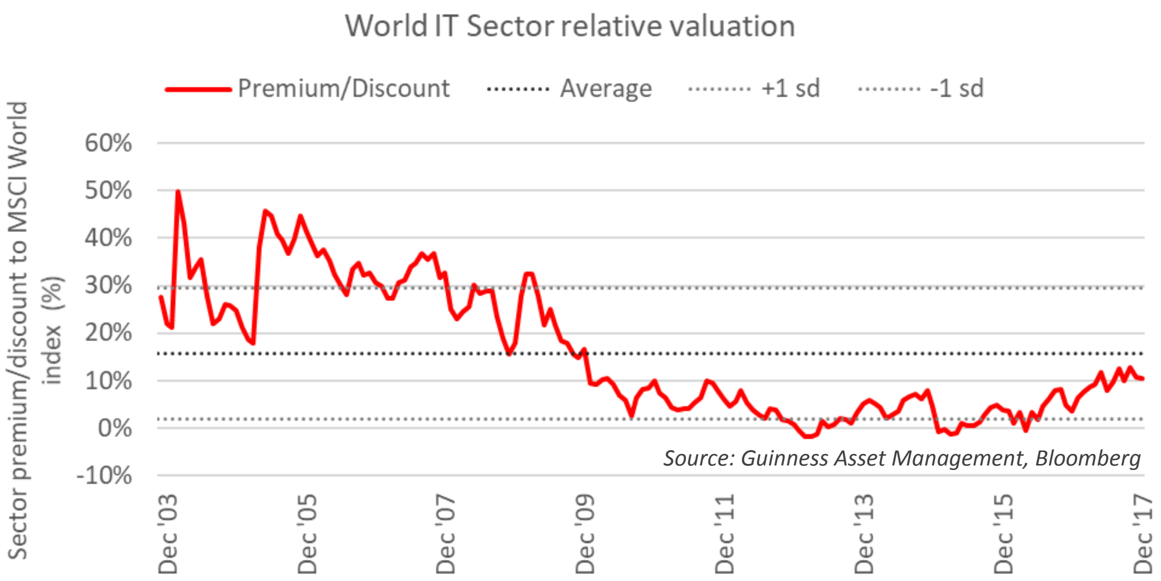
Certainly, the sector was looking particularly attractively priced through 2010 to 2015 where it was trading at around one standard deviation below the 20-year average premium, but there is still some way to go until IT stocks return to their average premium.

Chart 6



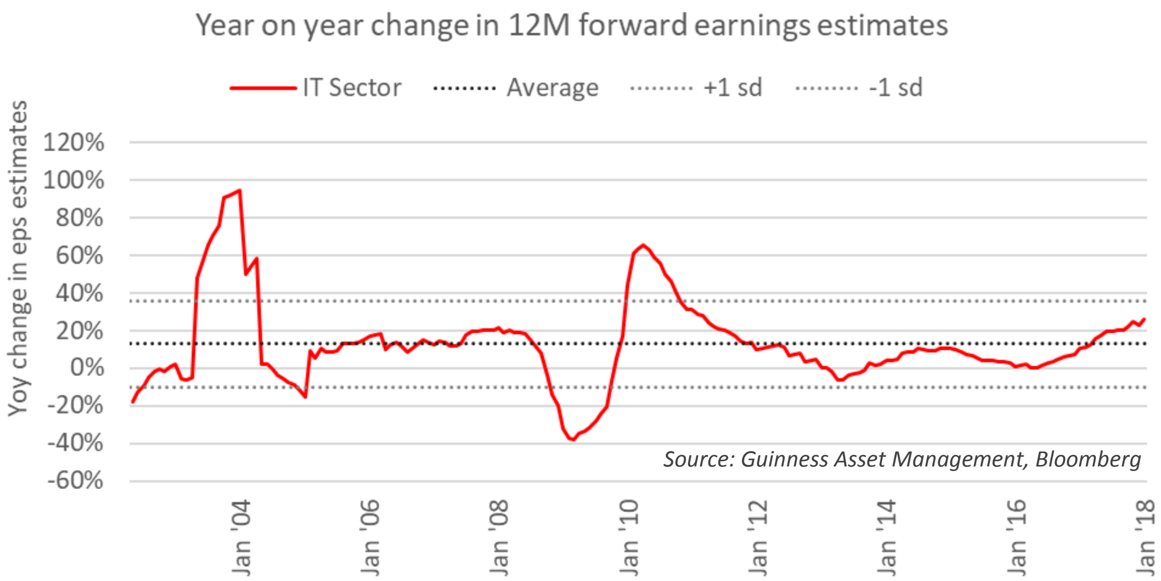
Even if we look at the same data but strip out the years in anticipation of the dot-com boom and the hangover of the bust (1998-2003), then the IT sector today trades at its average premium over this period (2003-2017).

Chart 7



It is interesting to look at how growth expectations for the sector have evolved over the last 20 years. As the next chart shows, earnings expectations for the sector have moved dramatically over this period. Expectations around the time of the dot-com bubble where clearly far too high and did not last long. The global financial crisis and ensuing recession had a meaningful impact on expectations of earnings growth, but these recovered reasonably quickly. Despite these gyrations in expectations, on average over this period analysts have expected the sector to grow its earnings at 13%. However, analysts currently expect IT sector earnings to grow at a much faster rate of 23%.

Chart 8



There seems therefore to be little to concern us when we take a broad, top-down view of the IT sector and compare it to historic norms. In summary:

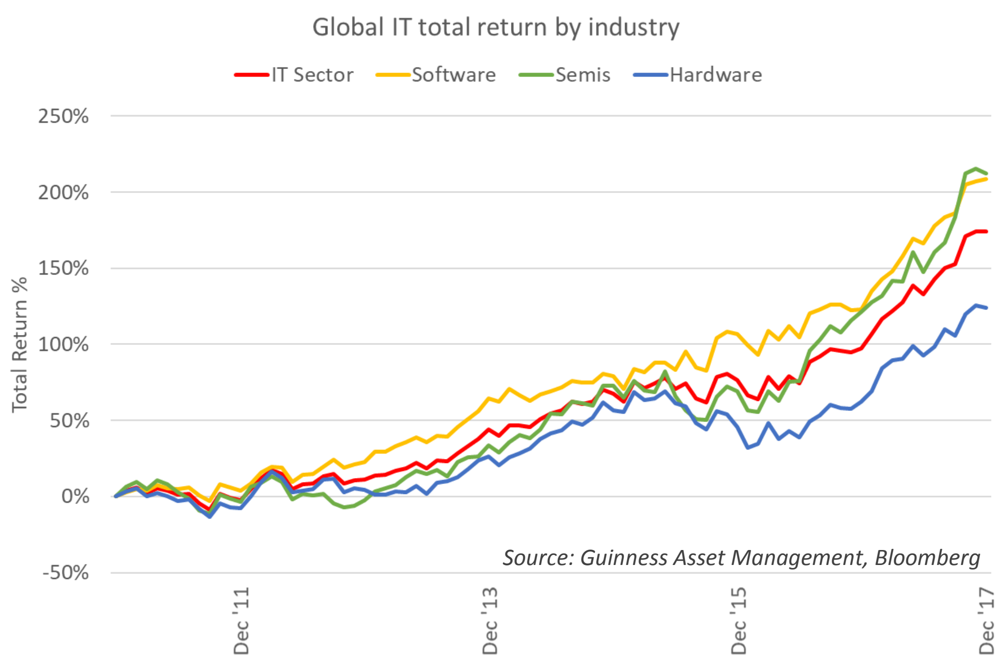
1. The IT sector has indeed performed well over the last seven years, but this has been driven by strong earnings growth, not a big multiple expansion like the dot-com bubble. The multiple expansion of the IT sector over the last seven years has been very similar to the MSCI World Index.

2. IT companies are trading on a multiple which is below the 20-year average premium to the MSCI World Index, with a considerable gap to make up before we are even back to an average (let alone an above-average) premium.
3. Currently analysts expect IT companies to grow their earnings at a faster rate than the 20-year average. This could be an area of concern if we thought analysts were being overly optimistic. However, with a global economy performing well as the U.S., Europe and China all release positive economic data, and various secular growth themes driving growth in IT (be it big data, internet of things, robotics, virtual and augmented reality, etc.), an above-average forecast of earnings growth seems far from outlandish.

We then wanted to go a little deeper to consider whether there are any subsectors with excessive valuation within the IT sector.

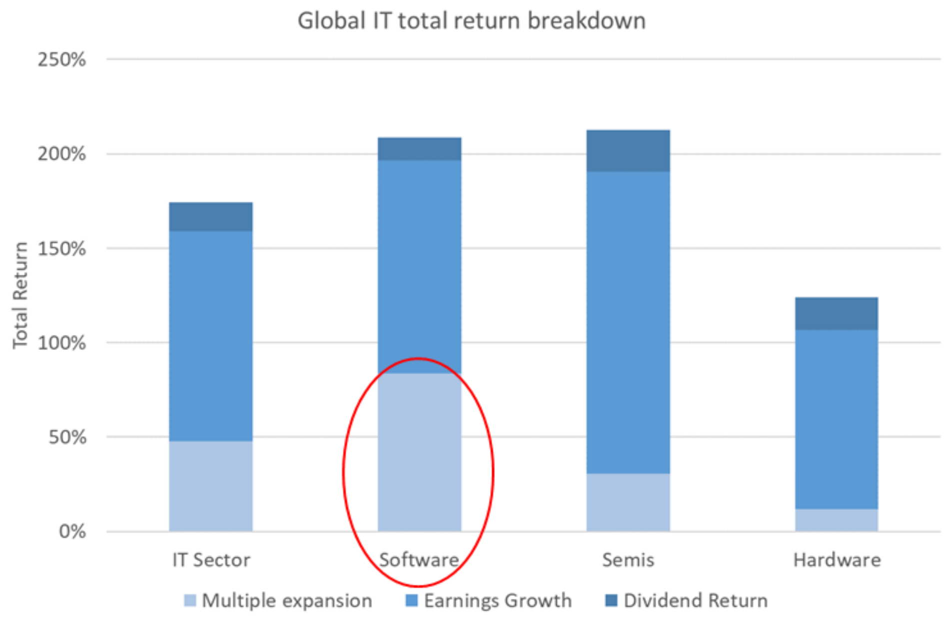
The IT sector can be split down in different ways, but we like to break it down into three industries: Software, Semiconductors, and Hardware. The chart below shows how these three have performed over the same period. We can see that the Hardware sector has lagged the average, but Software and Semiconductors have been particularly strong.

Chart 9



When we look at what has driven the performance of these three different industries we can see that again earnings growth has dominated their returns. However, it is noticeable that it is the Software industry that has seen the largest multiple expansion, while in Hardware and Semiconductors multiple expansion has been even lower than that of the MSCI World Index.

Chart 10



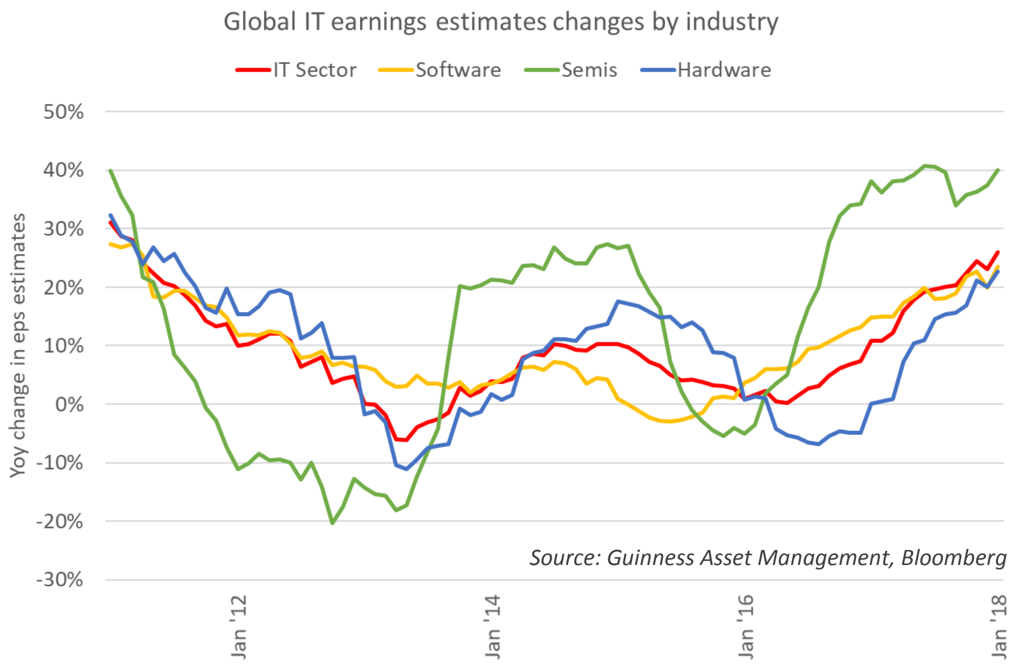
Source: Guinness Asset Management, Bloomberg

Looking at how valuations have evolved for these industries, it is interesting to note that back in 2010 they traded on very similar multiples, with Semiconductors being the cheapest. However, over the last seven years we have seen a significant re-rating in the Software industry to the point where it now trades at a 50% premium to Hardware and Semiconductors.

Chart 11

If we look at how forward-looking expectations of earnings growth have evolved amongst the three industries Semiconductors stand out for their wide changes in analyst sentiment. Semiconductor cycles have historically tended to be quite short, as new capacity is brought on line and before long new technologies emerge which require a new equipment cycle and new opportunities for profits. This goes some way to explain why the Semiconductor companies tend to trade at a discount to other IT companies.

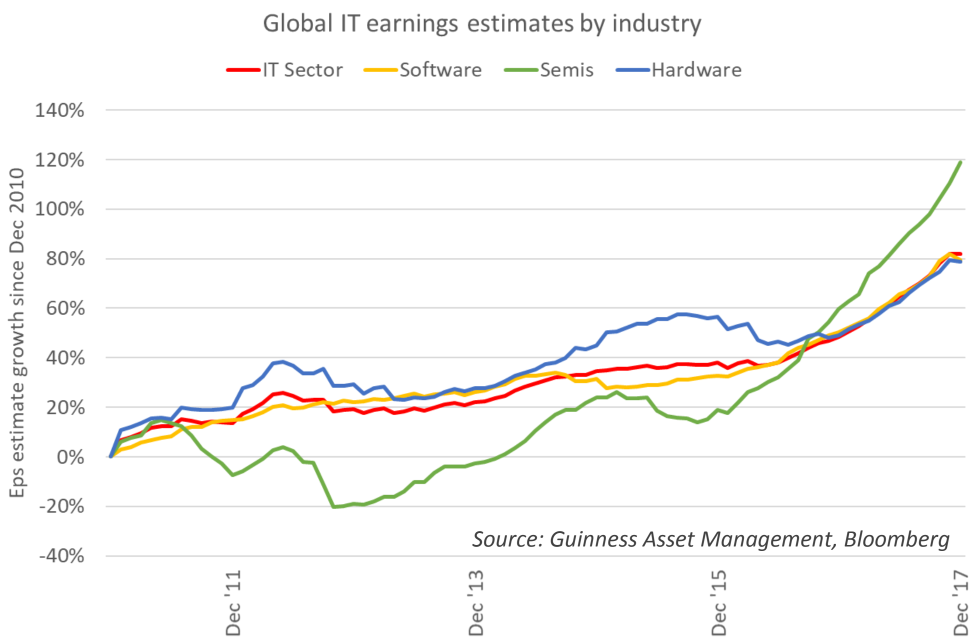
Chart 12



However, if we look at the cumulative growth in forward earnings estimates over this period we see that despite the Semiconductors' cycles they have seen the greatest growth in forecast earnings.

Given the industry trades on a multiple of just 15x and earnings look set to continue to grow at a good pace, this looks like an interesting balance of attractive value and growth. When you consider that a number of today's important innovation themes all demand more sophisticated and faster semiconductors, whether it is big data, artificial intelligence, machine learning or virtual and augmented reality, etc., despite the inevitable cyclicality the medium to long-term outlook looks favourable for these companies.

Chart 13



"We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten." Bill Gates

Investing in innovative companies

When selecting stocks for the Global Innovators Fund, we are not looking for the most innovative companies on the market. Rather, we want the best growth stocks where innovation is a success factor. We use a quality screen – looking for return on capital above the cost of capital, and balance sheet strength – to ensure our universe contains companies which have translated innovation into financial success. We also employ a value discipline to ensure we are not overpaying for future growth, recognising that hype can drive up valuations.

The Guinness Global Equities Team

Guinness Global Innovators Fund
Guinness Global Equity Income Fund

Portfolio Managers
Dr. Ian Mortimer
Matthew Page

Analysts
Joshua Cole
Sagar Thanki

Learn how we invest in innovative companies at guinnessfunds.com/global-innovators-fund

Guinness Global Innovators Fund

- Invests in companies benefiting from innovations in technology, communication, globalisation or innovative management strategies.
- We believe innovative companies that develop competitive strengths will deliver the key factors behind superior shareholder returns:
  1) **Higher than average return on investment**
  2) **Persistent growth over a business cycle**
- Managed for capital growth; holds a concentrated portfolio of large and mid-sized companies in any industry and in any region.

Benchmark	MSCI World Index
Geographic focus	Global
IA sector	Global
Fund launch	31.10.2014
Strategy launch	01.05.2003
Share class	Y GBP Acc: IE00BQXX3K83
OCF	0.99%

Guinness Global Equity Income Fund

- Providing investors with global exposure to dividend-paying companies.
- Managed for income and capital growth, and invests in:
  1) **profitable companies…**
  2) **that have generated persistently high return on capital for at least ten years…**
  3) **and are well placed to pay a sustainable dividend into the future.**

Benchmark	MSCI World Index
Geographic focus	Global
IA sector	Global Equity Income
Fund launch	31.12.2010
Dividend payments	July (interim) & January (final)
Share class	Y GBP Acc: IE00BVYPNY24 Y GBP Dist: IE00BVYPP131
OCF	0.99%

Global Equities Team

Dr. Ian Mortimer, CFA, joined Guinness Asset Management in 2006. He co-manages Guinness Global Equity Income and Guinness Global Innovators Funds.

Matthew Page, CFA, joined Guinness Asset Management in 2005. He co-manages Guinness Global Equity Income and Guinness Global Innovators Funds.

Joshua Cole joined Guinness Asset Management in 2017 as an investment analyst in the Global Equities Team.

Sagar Thanki joined Guinness Asset Management in 2017 as an investment analyst in the Global Equities Team.

Guinness Asset Management

Guinness Asset Management provides a range of long-only actively managed funds to individual and institutional investors. Founded in 2003, Guinness is independent and is wholly owned by its employees.

We believe in in-house research, intelligent screening for prioritisation of research and well-designed investment processes. We manage concentrated, high-conviction portfolios, with low turnover and no benchmark constraints. At heart Guinness is a value investor.

Since our establishment we have developed a variety of specialisms in global growth and dividend funds, global sector funds and Asian regional and country funds.

The Guinness funds sit within an Irish-listed OEIC. They are managed alongside a range of mirror SEC-registered funds offered to US investors by our US sister company, Guinness Atkinson Asset Management Inc.

We also offer an EIS service, AIM EIS, and Sustainable Infrastructure IHT Service for UK investors.