Investing like it's 1999

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Kevin Divney

The technology sector has helped fuel one of the longest economic expansions in the history of the United States. It's worth looking back to the late 1990s to recognize what expectations were created for the tech sector and better understand where we are today.

Although the 90s technology market *dotcom boom* ended in a burst bubble, expectations for the future of what technology could and would do, as an investment sector and economic force, were set. Many economists and analysts were correct in their predictions that the technology sector would unleash massive creative destruction, disrupt centuries-old business models and transform the way humans interact with each other around the world. In 1998, no one expected that a website plus UPS would equal Amazon.

What many were incorrect about was the timing of the realization of this grand future that computing power, the internet, satellite networks and wireless communications would give us. The tech bull run ended badly in March of 2000, when the Nasdaq peaked and then declined for the better part of two years.[1] Recriminations and blame always follows excess, but everyone was legitimately excited about what the future would bring.

Fast forward to 2019. Google is a verb, grandmothers know how to text and 31% of the world's population is on Facebook.[2] Movie stars and rock stars are now created on Netflix and YouTube, not so much in Hollywood or New York. Computing power, interconnectivity and access to information has democratized human interaction to a scale no one could have conceived of 50 years ago. To illustrate how much tech matters, look no further than a despot trying to control a populace uprising: The first thing they do is block social media. Cars are now learning to drive themselves, medical check-ups are happening remotely in our own homes and access to current and historical information is unprecedented. It's been theorized that a person living in medieval Europe during the dark ages would get no more information in their lifetime than was in a Sunday edition of The New York Times. Now, each morning, we see more information than that from our smartphones before our coffee is finished.

Justified tech-sector volatility

Today's technology companies rarely get the combinations of lofty-valuations-with-negative-earnings, as they did in 1999. Today, leading tech franchises have real earnings, real revenues and real customers. But most importantly, they generate massive profits and cashflow, the lion's shares of which is often reinvested to create the next innovation. While volatility can follow these stocks and make some investors nervous about technology stocks, we believe that volatility is justified. The stocks are volatile because the business is volatile—not because they are riding a cyclical trend, but because they are expanding market share, entering new markets, achieving record profit margins and disrupting every way business, consumption, healthcare, military and law enforcement has been done in the past. The profit margin for the S&P500® Index has doubled in the last 15 years, and approximately 38% of that doubling is due to the tech sector.[3] Yes, uncertainty does contribute to volatility, but volatility also represents the existence of opportunity, instead of signaling a mature industry or one that is in decline.

So what might this mean for your portfolio? The way to answer that question is to break it down into three parts: valuation, potential growth opportunities and fundamentals.

Valuation: Expensive but worth it?

Let's start with valuation first: According to the S&P500®, the aggregate technology sector looks more expensive than the broader market today, based on a trailing multiple basis. The tech sector also looks slightly more expensive relative to its 10-year average, but we believe higher profit margins and free cash flow generation are justification for those higher multiples. *Cheapness* as a strategy assumes some reversion to the mean, but in this case the mean keeps increasing, making a pure valuation argument one-sided. The quality of the profits is also high because, as a group, we have found that technology has less debt on their balance sheet relative to other industries and generates enough cash flow to largely fund expansion and investment in growth. Technology is more expensive than the broad market, but better relative fundamentals are driving that valuation.

Growth opportunities in and out of the tech sector

There are secular growth stories in areas such as Cloud adoption, 5G rollout, and video streaming, which are more visible to most investors in the tech companies held in their portfolios. But there are also growth opportunities in many non-tech sectors of the economy that are *technology-dependent.* In the retail channel, which has been massively disrupted by Amazon, there is a move toward omni-channel marketing—which integrates website, mobile, virtual and instore experiences to attract, retain and sell to customers. This retail-sector trend will require the latest innovations from the tech sector to realize this initiative, even if the initiative is driven by brick-and-mortar retailers.

In the energy sector, we have seen massive innovation in drilling techniques, which has led to the U.S. being the leading oil supplier in the world today.[4] These innovations were tech-led, as increased computing power enabled 3D geological simulations and artificial intelligence told drillers where to drill. Only 12 years ago, many investors were floating the theory that the world had reached *peak oil* and all the potential reserves had been discovered. Tech-led innovation in fracking and extraction de-bunked that theory, and we would expect innovations in explorations to continue in the energy sector.

In the transportation sector, artificial intelligence and machine learning will likely be giving us self-driving cars, more fuel-efficient engines and cheaper and faster shipping techniques. All of these phenomena have underlying dependencies on continued deployment and innovation in the technology sector.

Tech fundamentals

Lastly, let's discuss the fundamentals of the tech sector, which look good and may not be *mean reverting* any time soon. We believe the key indicators—returns on invested capital, profit margins, addressable market, competitive threats and pricing power—all look to be tailwinds relative to the broader economy. We believe interim volatility provides tactical opportunities for savvy investors. At various times, this volatility justifies overweighting or underweighting the entire group, but also demands that we take explicitly different views on the sub-sectors, such as technology hardware and equipment vs. software and services vs. semiconductors. Each of these subsectors are meaningful to the entire ecosystem, but each subsector experiences varying sub-cycles and differences in capital intensity. These variances creates opportunities to lean into the economic conditions which are favorable to the relevant sub-cycles.

The bottom line

Technology is part of all our portfolios, one way or another. Rewarding innovation and creative destruction while separating the winners from the losers is one of the main functions of capital markets. Today's tech dominance has validated many of the dreams of the 1990s have indeed come true. A best-practice portfolio process should link these dreams to reality, so that clients may benefit from what very well might be the Golden Age of Tech.