

Wealth Weekly

Tech Still a Portfolio Staple

WEALTH MANAGEMENT RESEARCH

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The technology sector has delivered total shareholder returns of over +20% pa for the last ten years, helped by the extraordinary growth of some exceptional companies. The probability of such high returns being repeated over the next decade doesn't look as high as it did ten years ago. But technology and innovation will continue to play an important role in enhancing the productivity and competitiveness of businesses, particularly in the current environment of fast-paced development and industry disruption. Technology stocks will probably remain important contributors to investment returns. The question is, which ones?

Another decade of +20% pa?

Having reviewed numerous technology and innovation funds, we believe active technology fund managers are well-placed to identify the best technology investment opportunities as they emerge. **Polar Capital Technology has a good performance track record and its managers are experienced and well resourced.** Their philosophy is to try to avoid the areas of greatest hype and to focus on themes with imminent, real growth prospects. This, together with the fund's positioning and track record make it appear slightly more cautious than some of the other tech funds we reviewed, which we believe is sensible following the sector's strong returns. For investors with a greater tolerance for bumps on the road to long-term performance, **Allianz Technology Trust provides a higher-octane exposure to the tech sector**, with a bias towards mid-cap stocks and a slightly more concentrated portfolio. Similarly, **Scottish Mortgage, which invests in innovative growth stocks in all sectors (not just technology/media/telcos) and in unlisted companies, has a lot to commend it for long-term growth investors.**

Themes of the week

Infratil on Monday announced that a number of enquiries has prompted it to review whether to sell its 65.5% stake in listed wind farm operator and developer Tilt Renewables. Tilt's stock bounced +12.5% on hopes the review might lead to a takeover. Renewable energy assets are flavour of the month (decade?). This driver of the "strong interest" in Tilt has also been reflected in the impressive recent share price gains of renewable energy generator/retailers Meridian Energy and Mercury NZ, which we attribute to fund flows from renewable energy ETFs rather than any improvement in fundamentals.

We already downgraded Meridian to UNDERPERFORM in mid-November, and we've now done the same with Mercury as its valuation has also overshot our assessment of fair value. **We prefer OUTPERFORM-rated Contact Energy and Genesis Energy**, which are trading on lower valuations, offer higher dividend yields, and stand to benefit if the NZ Aluminium Smelter (NZAS) does remain open. Negotiations between NZAS-owner Rio Tinto and the government on the smelter have continued. We understand there is increasing hope a decision on the smelter will be made before Christmas. Aluminium prices are currently high, which would support the case for Rio to keep the smelter open, but all outcomes are still possible.

In response to the economic shock of COVID-19 and part of Reserve Bank of New Zealand's (RBNZ) 'least regrets' strategy, **a new 'tool' is being rolled out this week, which will see the major banks able to access funding at extremely low rates of interest.** The RBNZ's aim with its Funding for Lending Programme (FLP) is to incentivise borrowing by putting further downward pressure on lending rates. By providing a cheaper source of funding for the banks than term deposits, the FLP is likely lead to term deposit rates falling even further. That means savers either face receiving a negative real return on their savings, or looking for alternative places to park their money.

Looking ahead

Progress in US stimulus talks and UK-European trade negotiations will probably be the main focus for markets this week. The European Central Bank will release its interest rate decision on Friday.

Technology Funds

Following the strong returns from the technology sector this year, we have reviewed and [profiled](#) 11 active and passive funds that invest in the tech sector and in innovative growth and robotics companies. For investors seeking broad-based technology exposure, our preferred technology funds are Polar Capital Technology (PCT.L), or its unlisted sister fund. Allianz Technology Trust (ATT.L) and Scottish Mortgage (SMT.L) are attractive alternatives for risk-tolerant investors with long investment horizons who are seeking higher conviction funds.

Polar Capital Technology (PCT.L)

PCT was launched in 1996. The UK-listed investment company aims to maximise long-term capital growth by investing in a diversified portfolio of technology-related companies around the world. The fund is managed by one of the largest Europe-based technology investment teams. The managers look for 90–100 quality, established companies that are well-positioned to exploit technological growth trends while avoiding areas that are over-hyped (too early in the S-curve) or approaching decline. **The managers' preferred technology themes are currently 5G and mobility, online ads and ecommerce, software-as-a-service, artificial intelligence, digital entertainment, cloud infrastructure and security, semiconductors, payments and fintech, and automation.**

In the current environment of heady valuations in parts of the sector, **PCT's more cautious approach** – seen in its more diversified portfolio, higher allocation to large-caps, good earnings quality, lower average stock volatility and slightly more palatable stock valuations – **might help it perform more defensively if the highly-priced mid-cap sector takes a breather.**

One disadvantage of PCT is that its board does not actively manage the discount at which its shares trade relative to its net asset value; as a result, investors should be prepared to hold on through periods of market weakness, when the discount (currently -5.1% by our estimate) could widen more than in the other tech funds we reviewed. (Polar Capital Global Technology UCITS is a similarly positioned unlisted fund that does not come with this discount risk; due to its legal structure it is available for PPM/wholesale clients only).

Allianz Technology Trust (ATT.L)

ATT is a UK-listed, closed-end investment company. The fund has been managed by the same small global technology team at Allianz Global Investors since 2007. The managers aim to achieve long-term capital growth by investing in quoted companies worldwide for which technology is a differentiating factor. The fund has a concentrated portfolio of 60–70 stocks. **The managers prefer mid-cap and higher-growth companies, which they believe have greater potential to multiply in value than mega-caps do, but which also have higher valuations.** They think about the portfolio in three groups: High growth companies (>20% pa) with high but justifiable valuations, growth-at-a-reasonable-price companies (+5–20% pa, e.g. the mega caps), and value or cyclical stocks with good prospects (e.g. semiconductor and pandemic-hit stocks). **The manager's favoured themes are cloud computing, cybersecurity, artificial intelligence and internet-of-things.**

For truly long-term, risk tolerant investors, **we would normally favour ATT among the tech funds for its benchmark-agnostic style and tilt to mid-cap and higher-growth companies.** The team's long experience and location in San Francisco, near the Silicon Valley epicentre of the global tech sector, and their access to an in-house primary research service, may give them an advantage in understanding expected demand for investee companies' products.

ATT's bias to growth companies will likely make it more volatile than Polar Capital Technology. **The risk we see for ATT in the current environment is that valuations of its higher-growth, higher-momentum companies could revert to lower levels,** for example in a broader market rotation from momentum towards value stocks. On the other hand, this risk may be offset by ATT's relatively modest positions (24%) in the mega-cap tech platforms, which face political/regulatory risks and which also appear fully valued. The co-managers' long tenures suggest personnel changes could be a risk in the years ahead. While the trust comes with some discount risk, the board's support of a -7% discount target limits the downside to the discount.

Scottish Mortgage (SMT.L)

SMT was established by the Baillie Gifford partnership in Edinburgh in 1909 to lend money for rubber plantations in Asia. The UK-listed, closed-end, global investment company continues to be managed by Baillie Gifford, but has long since shifted its focus to **investing in listed and unlisted equities with high growth potential over 5–10+ years.**

Speaking to academics, scientists and companies, the team sets out to identify trends, technologies and business models that look poised to undergo big changes. **They search for firms that are trying to transform industries,** like Amazon or Tesla, with the

expectation that some (but not all) will generate exceptional returns for shareholders over the long-term. This philosophy is based on the observation that the best returns come from a small number of exceptional companies. SMT is not purely a technology fund, but many of the innovative growth companies it tends to invest in have technology as a key component of their business models.

SMT has a long, strong track record. Its portfolio includes the mega-cap winners it backed as earlier-stage companies like Amazon (bought in 2005) and Alibaba (bought pre-IPO). **A key point of differentiation is that around a fifth of the portfolio is invested in small stakes in promising unlisted companies** such as Ant Group, Airbnb and SpaceX, most of which have proven technologies and business models and a lot of growth potential. **SMT's fees and expenses are very low** compared to other actively managed funds and particularly compared to private equity managers.

The fund's large size is a double-edged sword. It allows diversified access to unlisted investments, permits reasonably tight management of the discount in normal market conditions, and helps keep expenses low. But it could be a headwind to returns if SMT outgrows the new investment opportunities the manager can find and access. That said, the fund's global universe, permanent capital base and the manager's buy-and-hold style mean being oversized is less likely to be a problem than in a higher-turnover, open-ended fund with a smaller universe.

Themes of the Week

NZ Equities

Electricity Sector – Power Points – All I Want for Xmas is a Decision on NZAS – December 2020

Electricity company valuation metrics were stretched further in November as the sector continued its strong run, in particular Meridian Energy (MEL, +24.3% for the month) and Mercury (MCY, +19.8%). There was no fundamental news that would justify these strong gains, and interest rates actually increased over the month, which should be a headwind to valuations. Both MEL and MCY appear to be benefiting from ETF fund flows.

Having downgraded our rating on MEL to UNDERPERFORM in mid-November due to its high valuation, we are now also downgrading MCY to UNDERPERFORM for similar reasons. Both are expensive relative to their peers, and while they are quality companies, their premiums are unjustifiably high. If the NZ Aluminium Smelter (NZAS) remains open then both have limited to no upside. MEL will be providing a significant proportion of the electricity price discount if NZAS remains open, hence, FY22 and beyond earnings will be lower than the FY19 to FY21 period, regardless of the final NZAS decision.

We see better value elsewhere in the sector. **Our preferred electricity sector stocks, Contact Energy (CEN) and Genesis Energy (GNE) will benefit the most if NZAS remains open.**

NZAS negotiations have continued and we understand that there is a desire to reach a conclusion prior to Christmas. **We maintain our view that NZAS is more likely to stay open for longer, however, all outcomes are possible.** With aluminium prices very strong (the aluminium/alumina spread has been higher only 6% of the time in the past decade), it would not surprise us if RIO reverses its decision, or at least tries to retain the option to stay open. Our target prices reflect a 50% chance that NZAS remains open beyond August 2021, but our FY21 (and beyond) dividend forecasts continues to assume a hard close.

Fixed Interest

Exit TDs or face a negative real return

The Reserve Bank of New Zealand (RBNZ) officially kicks off its Funding For Lending Programme (FLP) this week, which will see the major banks able to access funding at extremely low rates of interest. The impact of the FLP is likely to see term deposit rates fall even further, meaning savers either face receiving a negative real return on their savings or looking for alternatives.

The aim is...

What the RBNZ is trying to do with the FLP is to provide a funding source at the lowest possible interest rate (in this case the Official Cash Rate of 0.25%). The RBNZ has already slashed the OCR to a record low, with further cuts possible in 2021. **The hope is that the FLP (alongside the ultra-low OCR) will encourage banks to lower interest rates for potential borrowers.** Encouraging individuals, households and businesses to borrow is how the RBNZ intends to help the economic recovery. There are two questions, however: firstly, will lower interest rates incentivise households and businesses to borrow more? And second, is there any demand for lending outside of residential property?

Deposit rates have fallen but not lending rates

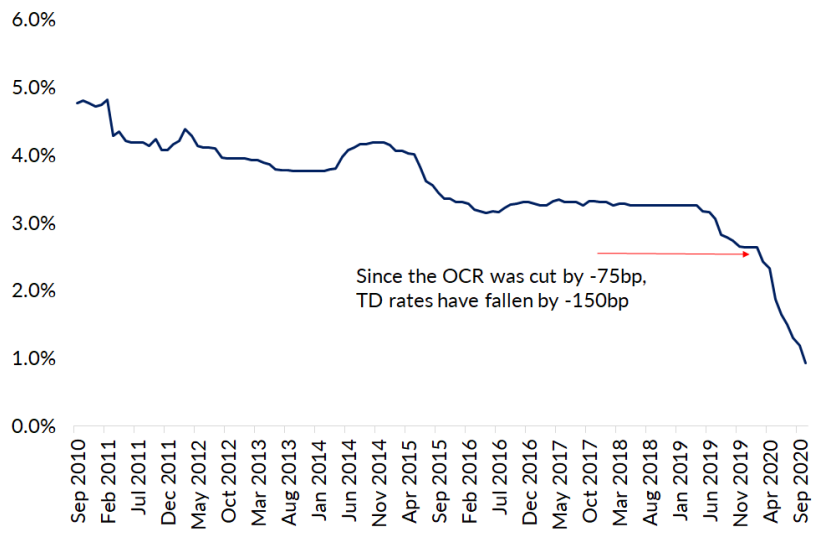
Even **the mere suggestion of the FLP has seen term deposit rates fall significantly in recent months** (see graph). Over the last year NZ\$13.6b has exited term deposits from the big four banks as interest rates have declined. The RBNZ is, however, concerned that lending rates have not fallen in comparison.

The RBNZ is clear that the measure of success of the FLP is not the scale of how much is borrowed (~NZ\$28b could be) but what the impact on lending interest rates is. It would only take one bank to use the FLP and offer loans to its clients at very low interest rates for competitive pressures to push all lending interest rates lower. If this occurs then the programme would be deemed a success.

Asset party to continue for a while yet

With interest rates already low, the prospect of term deposit rates potentially heading towards 0%, **a significant portion of the current NZ\$143b term deposits may be trying to find a new home. Will the destination be the equity market? Residential property? Or something else?** It may prove that asset prices continue to rise for some time yet.

Figure 1. Six month term deposit interest rate



Source: Forsyth Barr analysis, RBNZ

Research Worth Reading

New Zealand

ESG with a Capital "E" – Part of the Problem or Part of the Solution?

Mercury and Meridian Energy have been the winners from investor interest in renewable energy in recent years, with their valuations expanding to a 60% premium over Contact Energy and Genesis Energy. We believe the ESG winners of the next decade will be harder to pick as ESG investors move from avoiding investment in polluting industries towards a more scientific approach of aligning with the Paris commitments. We believe the level of greenhouse gas emissions will matter more for investment returns over the next 5–10 years. (Published by Forsyth Barr)

NZX (NZX) – Investor Day Insights

NZX's Investor Day reinforced our positive view of the company. We remain attracted to its 1) stable balance sheet, 2) wide diversification of revenue streams, 3) sensible management, and 4) momentum in its growth divisions. We see future contract wins in the Wealth Technologies division as a likely catalyst for the stock. **OUTPERFORM**. (Published by Forsyth Barr)

Heartland Group (HGH) – Valuation Remains Incongruous

HGH reiterating its FY21 NPAT at its AGM. We have increased our FY21 NPAT forecast as a result, but it remains lower than guidance due to 1) our a more cautious view on impairments, 2) risk of loan receivable growth softening in 2H21, and 3) expected net interest margin compression across the business. There is upside to our numbers in a bull case economic scenario. But considering HGH's risk profile, the level of macroeconomic uncertainty remaining, exposure to unsecured loans through Harmony and the ongoing elevated expenditure related to 'digital', we retain our **UNDERPERFORM** rating. (Published by Forsyth Barr)

Australia

Afterpay (APT.AX) – UBS SnapShot: November trading update

November represents a significant milestone for APT, with US sales surpassing Australia and NZ for the first time. However, the disclosures raised many questions, including 1) why APT has not provided a trading update for October; 2) whether sales were potentially pulled forward due to Black Friday Cyber Monday (BFCM) falling entirely in November this year; 3) what customer numbers, operating costs, credit performance & receivables growth were like. **SELL**. (Published by UBS)

Cleanaway Waste Management (CWY.AX) – Virtual strategy session feedback

CWY recently hosted the first in a series of virtual investor strategy sessions which will take place over the coming months. The first session focussed on energy from waste (EfW) and Cleanaway's Western Sydney energy and resource recovery centre (WSERRC) project. **ACCUMULATE**. (Published by Ord Minnett)

Qube Holdings (QUB.AX) – Better than expected 1Q leads to earnings upgrades.

Citi unwound the previously assumed conservatism in its forecasts and made the following key changes to estimates: 1) +3% increase in FY21 revenue and +1% in FY22/FY23, 2) higher margins given operating leverage, and 3) higher associates' earnings from Patrick Terminals. Citi retains a **BUY** rating, given the potential for positive news around Moorebank monetisation later in the year. Additionally, leverage has reduced following recent asset sales and the April 2020 equity raising, providing opportunity for strategic acquisitions. **BUY**. (Published by Citi)

Treasury Wine Estates (TWE.AX) – China duties cut market access – Downgrade to Lighten

TWE has responded to the 169.3% deposit rate imposed by China's Ministry of Commerce (MOFCOM) as a provisional anti-dumping measure with plans to 1) grow its global priority markets, notably via reallocation, 2) enhance its China business model and 3) change its operating model, i.e. reduce costs and cut its CY21 vintage intake. **LIGHTEN** from **HOLD**. (Published by Ord Minnett)

International

Amazon (AMZN.O) – AMZN Remains Best Positioned in eCommerce But Tough Comps are Ahead

FY20 has been an impactful year for ecommerce as COVID-19 has profoundly altered consumer shopping behaviour, accelerated the offline-to-online shift in commerce and pulled forward prior multi-year industry adoption curves. UBS now expects US ecommerce sales to grow at a +19% pa compound annualised growth rate from 2019 to 2024, compared to its pre-COVID estimate of +13%. While UBS continues to believe that AMZN is best positioned to benefit from a high ecommerce adoption rate and the shift in consumer shopping behavior, UBS does expect to see a return to more normalised growth levels in 2021 and beyond, while pointing to potential operating income margin upside as the company is lapping significant COVID-19 related investments. BUY. (Published by UBS)

FedEx (FDX.N) – Stars Still Aligning; F2Q21 Earnings Preview

In the latest installment of Citi's Stars Aligning series on FDX, Citi has increased its FY21-FY23 EPS estimates to US\$18, US\$20 & US\$23, respectively, to reflect a more constructive scenario in which FDX leverages sticky ecommerce growth to drive positive incremental Ground margins. On the Express side, air-cargo tightness and COVID vaccine distribution should bridge nicely to a post-vaccine recovery in global trade and business-to-business activity. In the Freight segment, positive less-than-truckload tonnage should couple with already solid pricing to support double digit margins. BUY. (Published by Citi)

NVIDIA Corp (NVDA.O) – AWS re: Invent 2020 Implications

Andy Jassy, CEO of Amazon Web Services (AWS), provided updates on Arm-based internal silicon and new instances in his annual AWS re:Invent keynote address. AWS highlighted that it is the only cloud provider that supports Intel, AMD, and Arm CPU processors through Amazon EC2 instances in the cloud, which helps AWS reinvent compute faster for its customers. Citi maintains its view of 80%+ GPU share in both gaming and data center long-term, through superior brand & technology, higher levels of R&D investments, and strong software platform appeal. BUY. (Published by Citi)

Salesforce (CRM.N) – Disappointed, But Maintaining our Buy

UBS maintains its BUY rating on CRM shares given solid checks on post-COVID CRM software demand. But UBS believes the near-term is now muddied by a modest miss in its current remaining performance obligation (cRPO), a Slack acquisition price of US\$28b that seems rich and a synergy story that isn't convincing, the departure of the CFO, and the likelihood that the long-term organic growth target of +20% needs to be trimmed by a couple of points. BUY. (Published by UBS)

Thermo Fisher Scientific (TMO.US) – 4Q20 Preannouncement: Organic Growth Guided to +40% as COVID-19 Revs Remain Elevated

TMO preannounced 4Q20 organic growth of +40% vs. prior guidance of +29% and consensus of +31%. The beat was primarily driven by stronger COVID-related revenues than expected (US\$2.4b in 4Q vs. prior guidance for US\$1.75b). EPS is now expected to be US\$19.17 on the year vs. prior guidance of US\$18.27. TMO provided more detail at an investor conference, indicating that the COVID-19 revenue beat was driven by sequential growth in the Polymerase Chain Reaction (PCR) testing business, sequential growth in the viral transport media business, as well as a sequential uptick in revenues related to COVID-19 vaccine and therapy production. BUY. (Published by UBS)

Calendar

Figure 2. Calendar

Date	New Zealand	Australia	International
7-Dec		AIG Services Index (Nov) RBA Governor Lowe Speaks ANZ Job Advertisements	UK: Halifax House Price Index (Nov) EU: German Industrial Production (Oct)
8-Dec	ANZ Business Confidence	Building Approvals House Price Index (3Q) NAB Business Confidence (Nov) NAB Business Survey (Nov) Bank of Queensland AGM	UK: BRC Retail Sales Monitor (Nov) EU: French Non-Farm Payrolls (3Q) EU: German ZEW Economic Sentiment (Dec) EU: GDP (3Q) JP: Household Spending (Oct) JP: Adjusted Current Account (Oct) GDP (3Q)
9-Dec	Manufacturing Sales Volume (3Q) Hallenstein-Glasson AGM	Westpac Consumer Sentiment (Dec)	US: EIA Short-Term Energy Outlook US: Nonfarm Productivity (3Q)
10-Dec		Melbourne Institute Inflation Expectations NAB Business Survey RBA Bulletin	US: JOLTs Job Openings (Oct) US: Crude Oil Inventories UK: GDP UK: Manufacturing Production (Oct)
11-Dec	Business NZ PMI (Nov) Electronic Card Retail Sales Food Price Index (Nov) Net Debt Forecast Economic Forecast	Westpac Banking AGM	US: Core CPI (Nov) US: Initial Jobless Claims EU: ECB Interest Rate Decision (Dec) EU: ECB Press Conference Adobe Systems 4Q20 Broadcom 4Q20
12-Dec	CFTC NZD Speculative net positions	CFTC AUD Speculative net positions	US: PPI (Nov) Medtronic AGM

Source: Forsyth Barr analysis

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