Disruptive technology: more relevant than ever

Over the long term, we believe investors will prize the innovative technology companies that can offer differentiated value to their customers and help businesses do more with less.

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In mid-November 2021, the equity market began to pull back, driven initially by concerns about rising interest rates and higher inflation. To date, technology equities have experienced the sharpest correction, given their relatively greater sensitivity to interest rates and starting point of elevated valuations: the price-to-next twelve months earnings ratio of tech equities is down 30% since mid-November. We see this correction as macro-driven and largely indiscriminate: tech fundamentals remain strong and we believe the companies in which we invest are well-positioned to potentially outperform in an inflationary environment. In our view:

- Inflation encourages businesses to invest in technology because it helps them to do more with less and identify solutions to bottlenecks and inefficiencies.
- Tech companies offering innovative products tend to exert considerable pricing power, allowing them to pass on input costs to customers.
- Active management is critical in this environment, as increased volatility and uncertainty are likely to drive greater stock-level dispersion moving forward.

We believe that, as we shift to the public cloud, transition toward Software-as-a-Service (SaaS) models adopt digital payment methods and build cybersecurity resilience. Technology companies – particularly those offering innovative software solutions in areas such as robotic process automation and customer experience management – will help other businesses reduce costs, improve operational efficiency, identify bottlenecks and predict dislocations before they occur. Furthermore, many of the companies offering technologies that underpin our transforming world – leading-edge chips and security solutions, for example – will command above-average pricing power. For these two primary reasons, we believe select innovative technology companies may benefit from inflation and that the current environment presents an potentially attractive opportunity for active investment in the future technology leaders.

Inflation encourages businesses to invest in technology

One potential solution for companies is investment in automation software. As labor costs increase, companies will look for ways to automate the simplest, most repetitive tasks using technologies such as Robotic Process Automation (RPA). RPA can free up employees to focus on higher value-add tasks, resulting in increased labor productivity and lower overall costs. For example, attended and unattended robots may help save thousands of manual hours

PHOTO: ARCHIVE GOLDMAN SACHS ASSET MANAGEMENT, ILLUSTRATION: SHUTTERSTOCK by reducing the time needed to collect, process and analyse data, thereby driving millions in savings in operating expenses. And automating manual and time-intensive processes – for example, those used in call centers – frees up employees to dedicate more time to deepening relationships with key customers.

Technology solutions are also an instrumental part of perfecting experience management, so that companies can retain top employees and customers as well as acquire new ones. Digital products and services can help companies navigate inflation, acquire new talent, and make timely and effective decisions. In 2021, the 'Future of Customers and Consumers Survey' of the International Data Corporation (IDC) showed that purposefully applying a customer-first approach to technology spending, results in companies seeing a higher return from their digital transformation investments.

Select technology equities have pricing power

Demand for truly innovative products and services is often less discretionary, and therefore more inelastic, than it is for traditional goods and services. Cybersecurity solutions are a key example of this. Cyberattacks can have devastating financial and reputational impacts on companies. To avoid these potential shocks, companies are increasingly relying on advanced solutions to secure their data. As attacks become more sophisticated, cloud migration weakens traditional perimeter network defenses and the proliferation of data sharing across geographies opens up new vulnerabilities, companies will have no choice but to upgrade their systems to be more resilient to complex attacks.

Beyond that, companies are proactively seeking innovative products: one such example is a new technology that resolves cyberattacks in real time, across network, endpoint, and cloud. The company that developed this product has been able to pass on cost increases to its end customers – while continuing to see accelerating demand – due to the quality of its innovation. Innovative product offerings and upselling to customers have generally been driving gross margin gains and strong operating leverage in the industry.

The case for an active approach to tech investing

We believe the market has underestimated the tailwinds that a new inflationary regime will provide to select technology companies – those that are either focused on helping other companies mitigate the effects of rising costs or that have pricing power due to the quality of their innovation. This underestimation can be partly explained by how traditional accounting methods do not fully capture the value of intangible investments – those made not in physical assets such as factories, but in intangible ones such as software.

Research and development – the engine of innovation – is expensed instead of capitalised and there is virtually no accounting disclosure of the quality of a given company's R&D. It is our view that this is where the power of active management comes in.

Looking Forward

We focus on leaning into long-term secular growth themes such as digitization and tech-enabled consumption to invest in the most innovative technology companies, no matter their size or country of origin. Going forward, we believe that tech fundamentals will remain robust – against a backdrop of strong corporate and consumer balance sheets – and that demand will continue to grow as the world continues to digitize. In a world where growth is increasingly scarce, we believe that the tech winners whose growth is fueled by anticipating and responding to the challenges companies are facing across sectors will be the most valuable and over the long term will be priced accordingly by the public market. ■

SUMMARY

Tech fundamentals remain strong.

Inflation encourages businesses to invest in technology because it helps them identify solutions to bottlenecks and inefficiencies.

Tech companies offering innovative products tend to exert considerable pricing power.

Active management is critical in this environment, as increased volatility and uncertainty are likely to drive greater stock-level dispersion moving forward.