Portfolio Manager Market Comment

Why is the BlueBox fund down this year, and what happens next?

There have been 4 headwinds for our fund this year.

1. The "profitless disrupters" that we shun, but which many others are obsessed with, have been trending down for more than a year, but investors only seem to have woken up to this in early January. These stocks were then mis-labelled with a phrase that suddenly appeared in research notes from mid-January: "profitless tech". Very few of these disrupters are actually tech stocks – they are almost all companies that buy tech and sell something else, disrupting those other industries, but (as often happens) this created some short-term collateral damage for real, profitable tech companies such as the ones we hold. This doesn't normally last very long and it's not something we tend to worry about.

2. A rapid acceleration in inflation increased the likelihood of interest rate rises, the prospect of which tends to hit tech stocks early, even though once rates actually start going up the tech sector has a history of outperforming, as the growth and pricing power of technology companies outweighs the negative impact of higher rates. So once again, this wasn't something we were too worried about, as it tends to work out well for our names, despite some initial pain.

3. The invasion of Ukraine hit one of our larger positions, EPAM, as discussed in recent factsheets. That position has now recovered to almost 4% of the fund, although we haven't added to it since early February, before the invasion. This turned out to be too early, as we have explained, but we do not like to keep adding to an underperforming position. We continue to like the name long-term, and we believe that the next few quarterly reports will show that the business is still operating strongly, albeit at lower margins while it manages the issues resulting from the conflict.

4. Finally, we suspect that there is a now a significant risk of recession, due to the commodity inflation and supply chain disruption caused by the war, along with lockdowns in China. As usual that risk has been at least partially priced into much of the tech sector well in advance, but there is still plenty of scope to fall further. Semiconductors are always taken out and shot first, and I think we have seen that happening already, DESPITE being in the middle of a massive global semiconductor shortage which still shows little sign of easing. We've therefore taken our semiconductor weight down from 40% to the low-30s – not because we think the sector is actually rolling over, but because if recession risk continues to rise, semis will continue to underperform (almost whatever the fundamentals) … until disaster hits their customers in the Industrials and other sectors, when semis should start to outperform (almost whatever the fundamentals). With 33% overall semiconductor weight we're still way above the exposure of almost any tech benchmark or tech fund, so we clearly remain very keen on the industry (especially semiconductor capital equipment)… we're just scaling that exposure back a little bit.

This puts us in the interesting position of absolutely loving current valuations, while being a little wary of the next few months. For example:

- Lam Research is currently at 13 x CY22 earnings, for 29% compound earnings growth 2019-2023, with high returns and massive barriers to entry, while acting as a key equipment supplier to an industry dealing with the biggest semiconductor capacity shortage of our lifetime; for the last 2 quarters its constraint has been supply, not demand. And guess what the supply constraint is: they can't get enough semiconductors!

- Taiwan Semiconductor Manufacturing (TSMC) is the clear global leader in cutting-edge chip production, with 28% annual earnings growth over the same 4-year period, but it is trading at only 16 x CY22 earnings.

- Microsoft isn't quite as cheap at 28 x CY22, and annual EPS growth is "only" 23% over the same period, but it's a business that is in the process of overtaking Amazon as the world's leading public cloud provider, due to its domination of the vast enterprise market, which is now moving en masse to the cloud.

Even if 2H22 earnings forecasts come down sharply, those valuations will still look very reasonable for such excellent profitable-growth businesses.

In summary, our approach is therefore to hold our course, but reef the sails a couple of points as everything has become a bit choppy and might get worse. If/when we get the Big Bad News it all becomes a lot easier, as profitable growth tech is likely to start to outperform very sharply. By then we should be putting the portfolio back to normal: shaking out the reefs and flying ahead of the wind. In a recession/slowdown, profitable growth becomes scarce, and our companies have the growth that everyone will be looking for.

Technology enablers remain the main engine of profit growth globally. We therefore remain fully invested in what we believe are the best-positioned profitable enablers, giving our investors exposure to the strongest technology trends, without the absurd valuations and poor business models of many of the high-profile, but profitless, disrupters.

William de Gale, Lead Portfolio Manager
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