Active Tech:

The Right Approach at the Right Time?

The Janus Global Technology team explains why they believe a convergence of factors within the technology sector creates unique opportunities for active managers.

The technology sector is in the midst of a generational platform shift as customers transition toward mobile and cloud computing. Aware of the opportunities made possible by these platforms, investors are eager to gain exposure to the sector, as reflected by recent capital flows, according to Bloomberg. However, many investors opt for low-cost passive strategies in technology, typically getting exposure through index funds or exchange traded funds (ETFs) that track a benchmark. According to the Janus Global Technology team, this is a mistake. In their view, passive strategies are ill-suited to navigating the disruptive forces now roiling the sector. By nature of their construction, passive strategies place no emphasis on identifying tech's eventual winners. Perhaps more hazardous, these strategies can expose investors to elevated risk by allocating money to what we believe are structurally challenged firms.

Passive Strategies are Often Geared Toward the Past

Passive strategies are largely market-capitalization weighted. As such, they tend to be backward looking. Brinton Johns, a portfolio manager of the Janus Global Technology strategy, frames the risk: "Benchmarks are weighted toward yesterday's winners. What the index doesn't do well is predict tomorrow's winners." Mr. Johns warns that passive investors are essentially placing a bet that the successful tech companies of the past will also be successful in the future.

The likelihood of so-called legacy companies effectively transforming their businesses to meet the demands of tomorrow's marketplace is remote, especially given the intensity of the current disruption. Global Technology strategy co-manager Denny Fish points out, "We are in the middle innings of the shift to the cloud and mobile, and that's when the secular headwinds are most dangerous." In fact, the team categorizes about one-quarter of the MSCI All Country World Information Technology (ACWI IT) Index as legacy companies, with the majority of these structurally challenged. These are often the companies that grew into their large market capitalization – and thus prominent position in the index – by providing the products and services of a bygone era.

Active Investing Focuses on Tomorrow's Tech Leaders

Some may doubt that today's tech giants could become dislodged, but that, however, is what the history of the sector illustrates. During the era of mainframe computers, tech's market cap was dominated by computer makers. As the sector experienced its initial platform shift – from mainframes to personal computers (PCs) and servers – legacy mainframe companies lost relevance. PCs and servers gave rise to a powerful software industry, as value shifted from hardware to operating systems and applications. Simultaneously, growing networks and wider usage of PCs created opportunities for communications equipment and semiconductor companies. Then, with the widespread adoption of the Internet nearly two decades ago, an entirely new industry rose to power.

Consider: Between 2011 and 2016, the share of computer hardware companies in the MSCI ACWI IT Index declined from 19.4% to 17.5%. The decrease would have been more precipitous but for Apple's commanding presence in the benchmark. Meanwhile, the share commanded by Internet firms jumped from 8.8% to 20.5%. This five-year period saw significant turnover within the index, as several marquee names were replaced by fast-growing innovators.

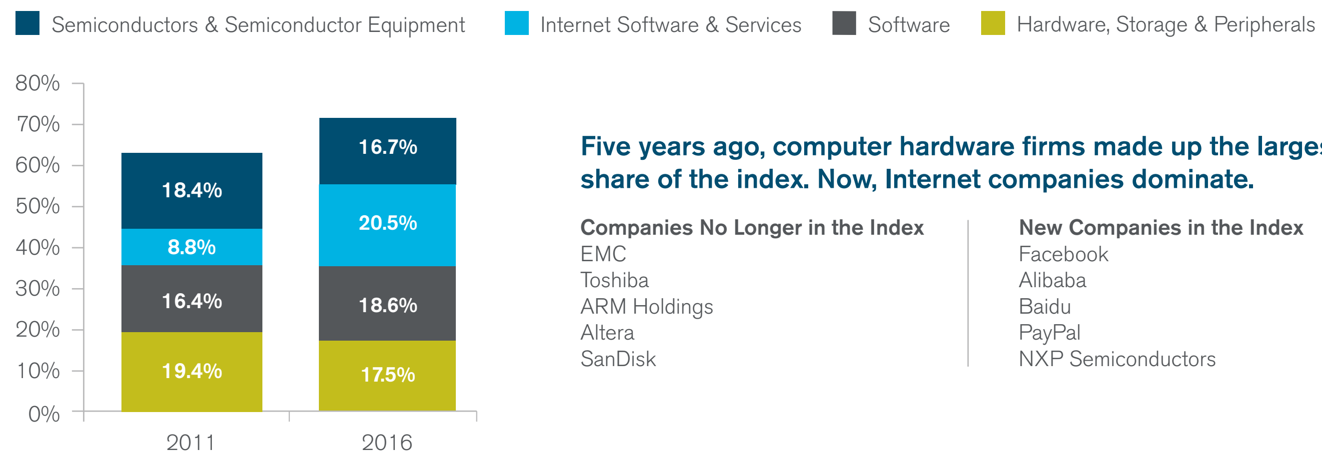
Rather than assume the existing landscape remains intact, Mr. Johns states that investors must deduce what the dominant ecosystems will be in three to five years. "This requires deep fundamental research, with the goal of identifying which disruptors will become the large caps of tomorrow," he says. Such analysis also places an emphasis on identifying which legacy companies can reinvent themselves. "When we see adaptability, we get excited," adds Mr. Johns, noting that few companies tend to successfully navigate these platform shifts. "The goal is to gain exposure to them, while avoiding the rest," he says.

While active management is not without risk, Global Technology strategy co-manager Brad Slingerlend, CFA, sees opportunities for active managers. "An active manager can take advantage of this disruption by using methods unavailable in passive vehicles. The most important thing we can do is choose not to invest in challenged companies," he says. Mr. Fish adds that active managers can also overweight fast-growing disruptors, which could become acquisition targets for struggling incumbents looking to remain relevant.

A Handful of Companies Now Dominate Passive Strategies

A bias toward yesterday's winners is not the only risk associated with the market-cap weighting used in index construction. The growing number of mega-cap tech companies has led to a top-heavy index. Such concentration runs counter to the diversification benefits that passive strategies purportedly offer. In 2006, the 10 largest companies comprised 39% of the MSCI ACWI IT Index, while the top 20 names accounted for 54%. By 2016, the index's allocation toward the 10 and 20 largest positions rose to 47% and 62%, respectively. This increased concentration coincided with Apple's entry into the smartphone market. For many passive investors, it would come as a surprise to learn that a single firm accounted for more than 10% of their technology portfolio.

EXHIBIT 1: CREATIVE DESTRUCTION
COMPOSITION OF MSCI ALL COUNTRY WORLD INFORMATION TECHNOLOGY (ACWI IT) INDEX, 2011 VS. 2016



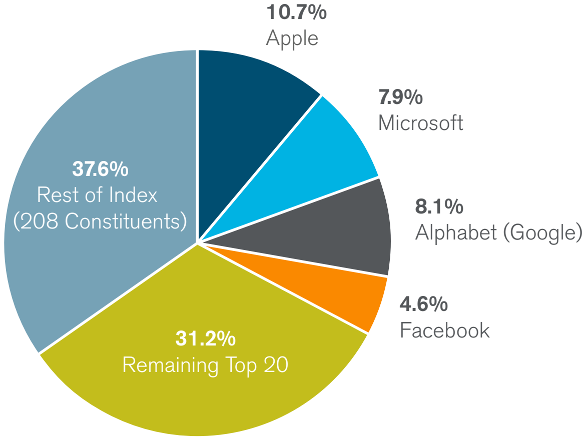
Five years ago, computer hardware firms made up the largest share of the index. Now, Internet companies dominate.

Companies No Longer in the Index	New Companies in the Index
EMC	Facebook
Toshiba	Alibaba
ARM Holdings	Baidu
Altera	PayPal
SanDisk	NXP Semiconductors

Source: MSCI

Notes: EMC, Toshiba, ARM, Altera and SanDisk were the five largest companies by market cap as of 12/30/2011 that were no longer in the index as of 12/30/2016. Facebook, Alibaba, Baidu, PayPal and NXP Semiconductors were the five largest new additions to the index by market cap as of 12/30/2016.

EXHIBIT 2: TOP HEAVY
COMPANY WEIGHTINGS IN THE MSCI ACWI IT INDEX, 2016



Given the massive market capitalization of leading tech companies, just four firms account for 31% of the index. Only 20 companies comprise 62%. This calls into question the diversification benefits of passive strategies.

Source: MSCI. Data as of 12/30/2016

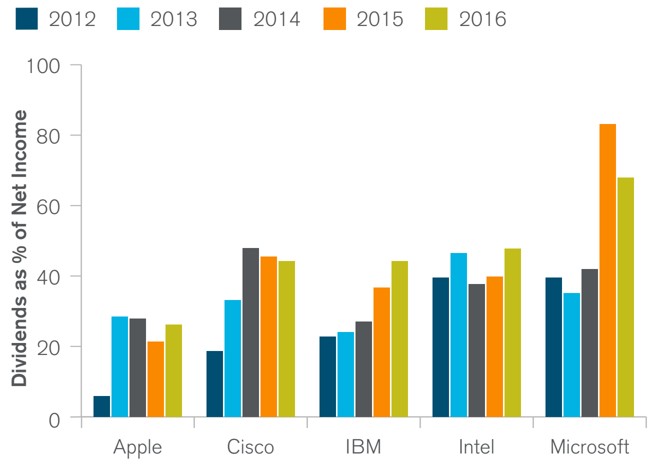
Even with names such as Facebook and Alphabet making up a greater share of the tech sector today, several legacy companies remain well represented. In fact, hardware, storage and peripherals companies, along with semiconductor firms, still comprise roughly one-third of the index. Some of these companies will withstand the mobile/cloud transition intact, but those with entrenched business models aimed at the past are at serious risk of losing market share. Despite the clear headwinds, passive investors are often saddled with exposure to these firms. Active managers, on the other hand, can choose to underweight the specific companies or subsectors at greatest risk of obsolescence in the fast-moving technology sector.

The Long Reach of Low Rates

Flows into passive investments are not the only factor in propping up challenged companies. Low interest rates have fueled a hunt for yield, benefiting so-called bond proxies. Many legacy tech companies fit this description because they are cash-rich and can reward shareholders with dividends and share repurchases. Many of these firms have also used low borrowing costs to relever balance sheets to boost returns. The result has led to these tech companies being valued based on their ability to return cash to shareholders in the near term, rather than which management teams are creating the defining products of tomorrow. As Mr. Slingerlend says, "Every dollar that a legacy tech company allocates toward dividends and share repurchases is a dollar not spent on new products and innovation."

Some of these challenged companies enjoy large weights in the index, but quite possibly find themselves with an empty future. With the expectation of rising U.S. interest rates and accelerating economic growth, the lofty valuations of bond proxies may reverse course as investors refocus their sights on innovative technology companies, capable of delivering steady earnings growth.

EXHIBIT 3: THE RISE OF DIVIDENDS
MANY LARGE TECH COMPANIES ARE ALLOCATING AN INCREASING PERCENTAGE OF PROFITS TO DIVIDENDS



Sources: Bloomberg, MSCI

Notes: Chart reflects five largest dividend-paying companies by market capitalization in the MSCI ACWI IT Index as of 12/30/2016. Figures are annual and for corporate fiscal years.

Investing involves risk, including the possible loss of principal and fluctuation of value.

There is no assurance that the investment process will consistently lead to successful investing. When valuations fall and market and economic conditions change it is possible for both actively and passively managed investments to lose value.

Technology industries can be significantly affected by obsolescence of existing technology, short product cycles, falling prices and profits, competition from new market entrants, and general economic conditions. A concentrated investment in a single industry could be more volatile than the performance of less concentrated investments and the market as a whole.

Differences between compared investments may include objectives, sales and management fees, liquidity, volatility, tax features and other features, which may result in differences in performance.

The views presented are as of the date published. They are for information purposes only and should not be used or construed as an offer to sell, a solicitation of an offer to buy, or a recommendation for any security or market sector. No forecasts can be guaranteed. The opinions and examples are meant as an illustration of broader themes, are not an indication of trading intent, and are subject to change at any time due to changes in market or economic conditions. There is no guarantee that the information supplied is accurate, complete, or timely, nor are there any warranties with regards to the results obtained from its use. It is not intended to indicate or imply in any manner that any illustration/example mentioned is now or was ever held in any Janus portfolio, or that current or past results are indicative of future profitability or expectations. As with all investments, there are inherent risks to be considered.

In preparing this document, Janus has relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources.

Janus Capital Management LLC serves as investment adviser.

FOR MORE INFORMATION CONTACT JANUS

151 Detroit Street, Denver, CO 80206 / 800.668.0434 / www.janus.com

C-0317-8214 03-30-18

188-15-48214 03-17