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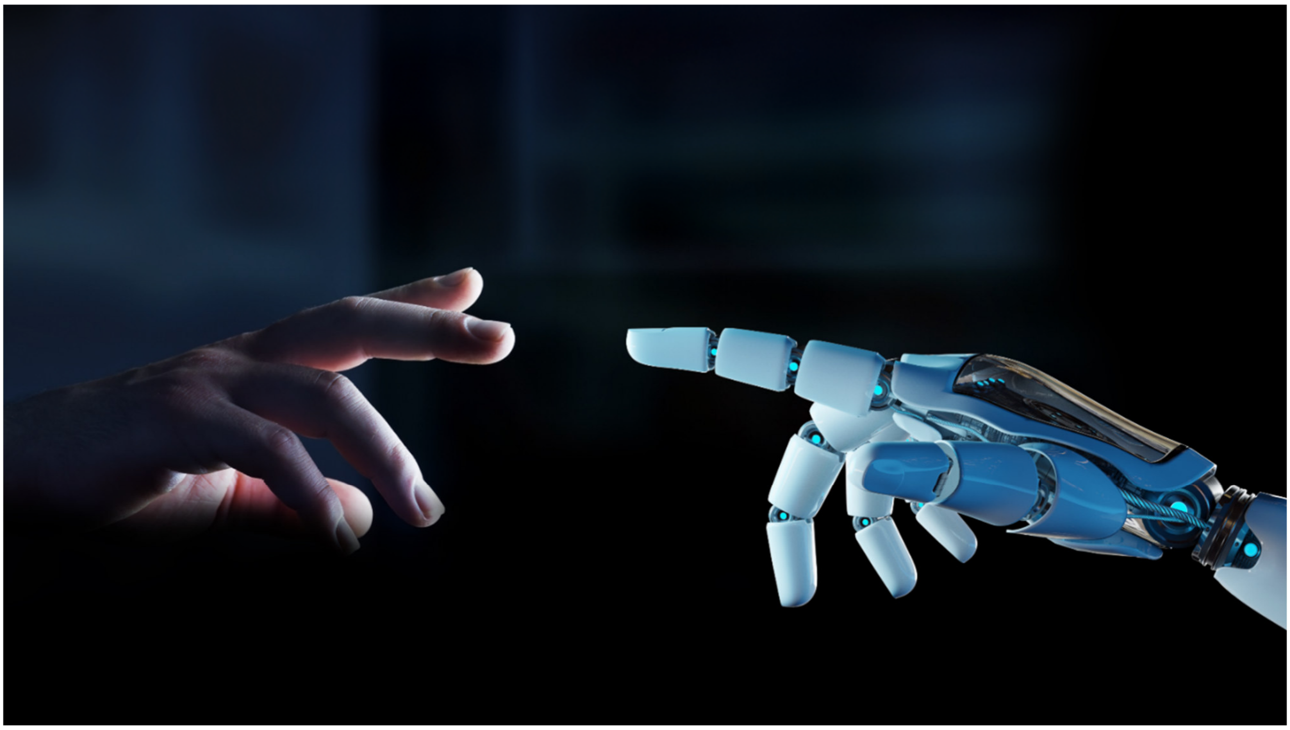
Investment letter – 1st Quarter 2024

Is the technology sector overvalued?



With the euphoria surrounding the topic of artificial intelligence and the strong performance of the technology sector since the end of 2022, concerns have grown that the sector may now be too expensive. The issue in assessing this question is multifaceted. The technology sector consists of the three sub-sectors: software, hardware, and semiconductors. Each of these three sub-sectors has different demand dynamics, margin profiles, growth rates, and valuations. Both the sector and the sub-sectors are dominated by Apple, Microsoft, and NVIDIA, which together make up about half of the technology sector with market capitalizations of several trillion USD each. Since 2018, large technology companies like Alphabet (formerly Google) and Meta (formerly Facebook) have also been allocated to the communication sector rather than the technology sector. Broad overall assessments at the level of an overarching sector do not do justice to these circumstances.

The same can also be said for regional evaluations. A statement like 'Europe is attractively valued compared to the USA' is not meaningful without considering the different composition of the sectors. While in Europe the finance and industrial sectors each account for about 15% of the total, in the USA the technology sector, with around one-third, is by far the most significant sector. It is undisputed that the financial sector, especially since the financial crisis, does not have the best track record, while the technology sector continues to gain importance. From the trend towards smartphones, cloud computing, and most recently artificial intelligence, no consumer and no company can escape digitization. Accordingly, their share of economic output has increased, which is rightly reflected in market capitalization.

For a specific assessment of valuation, the widely used price/earnings ratio falls short. The price reflects not only the current earnings but also their growth prospects. The entire technology sector shows a significant growth premium compared to the overall market. Especially in economically challenging environments, this is valuable and essential to at least keep pace with inflation. Thus, a valuation premium based on current earnings compared to the overall market is justified.

Additionally, important is that profit growth can be achieved both through revenue increases and efficiency gains. The latter, due to scalability, leads to above-average high margins in the technology sector. According to our assessment, these could be even higher, especially for the large technology companies, since efficiency was not a priority until recently due to strong growth.

Considering all the above-mentioned circumstances, the valuation of the technology sector has indeed become more demanding compared to the overall market. At the same time, the excess growth has accentuated in the current environment. Occasionally, future expectations regarding artificial intelligence may have led to valuations that have somewhat outrun earnings development. Overall, we consider the valuation to be in an appropriate relation to the growth.

As active investors, we have the privilege of not having to buy the entire sector. Our focus is exclusively on finding companies where the earnings prospects are in an attractive relation to the valuation.

Zurich, end of March 2024