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Investing in technology companies in a high interest rate environment

James Dowey, Co-manager of the Liontrust Global Technology Fund

My teammates and I in the Liontrust Global Innovation Team see a huge opportunity right now to invest in technology companies. In a nutshell, the prospects for innovation have never been better and after the big hit to technology companies' share prices last year, valuations are attractive.

However, we often encounter the argument that technology companies owe much of their success over the past decade or so to low interest rates and that higher interest rates over the coming years will hamper them. Indeed, we think this is probably the consensus opinion on the matter.

We believe this consensus is wrong and that the resultant negative sentiment currently prevailing on the stocks only adds to the opportunity. While we believe it is exceedingly difficult to predict the path of interest rates over the coming years – and we do not take a strong view on it – we very firmly believe that should higher rates be sustained they will not affect the progress of good technology companies or our ability to achieve excellent returns investing in them. There are three reasons for this.

Technology companies won on the fundamentals not rates in the 2010s

First, technology stocks performed strongly in the 2010s not because they were pumped up by low interest rates but because technology companies delivered on the fundamentals. Over the course of the decade, technology stocks as represented by the S&P technology sector index returned about 17% per year. This is clearly an excellent rate of return and ahead of the still strong overall S&P 500 annualised return of 13.5%, the MSCI World return of 10% and the FTSE All Share return of 8%. How much of that 17% per year was driven by technology companies' fundamentals and how much by multiple expansion? The answer may surprise tech naysayers. A huge 15% of the 17% was due to fundamentals: 14% of earnings per share growth per year and an average annual dividend yield of 1%. Only 2% per year was due to expansion of the price-earnings multiple. Huge fundamental successes over the decade such as Apple (25% average annual EPS growth) and Google (17% average annual EPS growth) trip off the tongue but there were many more in the ranks.

Further, the contribution from multiple expansion was arguably justified, with technology companies coming off the back of a decade in which they were hated by investors following the tech bubble and subsequent bust around the turn of the century. Today, the technology sector sits, as it did at the end of the last decade on the eve of Covid, at a 30% premium to the market, having fallen as low as 0% in 2012. We believe this is reasonable for a sector with significantly higher structural growth and lower leverage than the rest of the market.

What are the prospects for earnings growth for technology companies over the coming years? They are exceptionally strong, driven by huge innovation across numerous technology areas. One of these is of course artificial intelligence. AI may have only recently captured the public imagination but it is a game changing innovation long in the making and for a long time underrated too. It is not another fad like crypto, but a technology that is already driving customer value, market share gains and profits for many of the companies in which we invest.

But above all, the hallmark of real innovation is that it can dramatically drive down prices for customers. No other economic force of nature can hold a candle to it in this regard. In a world of crises of high living costs and costs of doing business driven by higher interest rates and inflation, it is a godsend and will be in greater demand than ever.

Covid and valuations

Second, technology stocks were hit very hard in 2022 by rising interest rates, having surged in 2020 as rates plunged during Covid. Big changes in interest rates matter a great deal for stocks through their impact on valuations, and indeed tend to impact technology and other growth stocks much more than the market overall.

However, this impact is felt immediately and in full as and when interest rates change. Once stock valuations have changed with moves in interest rates, higher or lower *levels* of interest rates do not have an ongoing impact on them. This simple but often conflated distinction has been rigorously demonstrated by researchers at Yale University and AQR Asset Management[1], and in a recent paper by world leading financial economist John Y Campbell of Harvard University and co-authors[2].

From today's valuation levels, we believe that technology companies that can deliver strong earnings growth and maintain their competitive position over the coming years will also deliver strong stock returns. In considering whether changes in valuation multiples over the next few years are likely to help or hinder, it is clearly highly preferable to be able to take 5% interest rates instead of 0% as a starting point.

The current cycle of interest rate increases that began in March 2022 – and began affecting the stock market in late 2021 – may not quite yet be over, but sooner or later it will be, along with its potential impact on technology stock valuations. Indeed, incremental interest rate increases by the US Federal Reserve appear to be having significantly less effect, technology and other growth stocks now leading the market even as rate hikes continue.

Profitability beats growth at any cost

The team and I talk to the companies we invest in on a constant basis and have made three trips to Silicon Valley during the past 12 months to meet many of those based there face-to-face to understand how they have been managing the fall-out from the significant share price declines in late 2021 and 2022 and other macro challenges. One thing is striking. While we all wait and wonder if a recession is coming, the technology sector is already in one and has been for nearly two years.

Covid-era growth in areas such as e-commerce and technology equipment was wrongly extrapolated and there has been a painful period of reckoning. But many excellent technology companies have been extremely adaptable and fast to get stuck in, cut costs and re-focus the business away from growth at any cost to profitability. Take Shopify, which chastened by a brutal 80% stock price decline from peak to trough has laid off 30% of its workforce, scrapped two-thirds of its R&D projects and its plans to build out a physical logistics infrastructure to re-focus purely on its industry leading e-commerce services. It is up 150% from the bottom with huge upside ahead. Technology companies were first in to the macroeconomic slowdown and are first out, stronger and leaner, while much of the rest of the economy lags behind.

It makes complete sense to us that technology companies are leading the market this year. But the much more important point is that this focus on profitability will be key to sustained success in a world of higher interest

[1] Maloney T & Moskowitz T (2020) "Value and Interest Rates: Are Rate to Blame for Value's Torments?", Journal of Portfolio Management
[2] Campbell JY, Giglio S & Polk C (2023) "What Drives Booms and Busts in Value?. Working Paper.

rates. It makes little sense to us that many commentators have advocated focusing on capital-intensive "old-economy" companies if interest rates stay higher. If capital is more expensive then this favours the opposite: capital-light businesses with high returns on invested capital that can easily clear the higher hurdles for profitable investment, particularly those with critical scale and laser-focused on profitable growth.

Pre-Covid, AirBnB had just short of $5bn of annual revenues and was operating close to break-even. The business lost almost all its revenues during the lockdowns but having survived this shock found that demand returned to 95% of its pre-Covid level before it even had a chance to spend any marketing dollars. This was a good thing to learn. It is now making close to $4bn of free cash flow from revenues of around $9.5bn and achieving a return on invested capital of over 20%.

Companies like this will love higher interest rates because they will take market share much more easily than ever before against both the zombified companies on the wrong side of innovation that have been building up debt to stay in the game over the past decade, and their sub-scale and unproven start-up competitors who may now find it harder to finance unprofitable growth.

We have great confidence in the ability of the technology and innovative companies in which we invest to win and deliver high investment returns, no matter if rates stay high.

Key Risks

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

Investment in the Fund involves foreign currencies and may be subject to fluctuations in value due to movements in exchange rates. The Fund may invest in emerging markets/soft currencies or in financial derivative instruments, both of which may have the effect of increasing volatility.

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