

## Technology Sector Driving Disruption

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### A Closer Look at Technology & Growth

Harbor has the benefit of sharing thoughts and perspectives with a diverse set of asset management partners around the globe – up and down the cap spectrum, across different styles or geographies – we can go anywhere.

Our focus in this ProActive update is around technology, and more specifically how we are identifying high quality disruptive companies during this unique time in growth. Joe Duffy, Investment Specialist at Harbor is fortunate to be joined in this virtual conversation by two experienced growth investors: Will Muggia, President, CEO and CIO at Westfield Capital Management Company and Blair Boyer, Managing Director & Co-Head of Large Cap Growth Equity at Jennison Associates LLC where we'll share our thoughts.

**Joe Duffy (JD):** U.S. equity markets experienced increased volatility in the beginning of Q420 driven primarily by corrections within technology stocks, as well as high volatility and high momentum stocks. Given the pullback, valuations in the technology sector have meaningfully declined while growth expectations have continued to trend higher. In fact, forward looking price-to-earnings estimates (FY1) for stocks within the Russell 1000 Growth Technology Index (“the Index”) have fallen from 36.8x as of 8/31/2020 to 27.7x as of 4/30/2021, a decline of nearly 25%. Over the same period, consensus 3 - 5 yr. earnings per share growth expectations for the Index rose from 15.7% to 17.7%, marking an increase of 12%. Given these fundamental changes, what are your thoughts about this segment of the market for 2021 and beyond?

**Blair Boyer (BB):** Technology remains the largest weight in our portfolios as it has been for some time and offers a large number of long-duration growth opportunities. Technology is driving transformation of both enterprise and consumer behavior. Enterprises are increasingly embracing the performance and cost benefits that accompany digital transformation. The pandemic heightened the urgency of this imperative, leading to an increase in spending intentions in 2021 and beyond. For the consumer, new applications create ubiquity across connected devices, driving the growth in e-commerce, entertainment, and social media, and resulting in demand for electronic payment technologies to complete transactions wherever and whenever they choose.



In terms of share prices year to date, investors have been digesting the substantial gains in technology stocks from the market bottom on March 23, 2020. Notwithstanding recent share price weakness in technology and other growth areas, we have been very pleased with full year 2020 earnings and more recently with the first quarter 2021 reports of the companies in our portfolios. However, quarterly earnings reports are not always share price catalysts. What you hope is that they are confirmatory of the investment thesis, which remains the case following the current earnings season. So to your point, Joe, valuations of growth stocks have become more attractive given these two developments.

**William Muggia (WM):** We are cautious on the high multiple technology names as valuations remain above historical levels, particularly in software and Internet. We believe that the most highly-valued companies will require a digestion period to grow into their multiples, as we saw following the 2014 and 2016 tech draw-downs. We are focused on identifying strong franchises with above-average revenue and earnings growth prospects trading at reasonable valuations. We believe that companies with these characteristics can outperform the market even in periods of tech multiple compression.

**JD: Please share your thoughts around growth and value given where we are in the market cycle. As the long-term debate continues regarding which style is more favorably positioned for the road ahead - do you believe growth, and more specifically technology, still has room to run?**

**BB:** Our team focuses on identifying companies creating long-duration growth drivers with strong management teams adept at using technology to build lasting competitive advantage. From this perspective, we see more long-term opportunities among growth companies.

Diversification is an important characteristic of an investor's portfolio. The allocation to growth need not be to the exclusion of an allocation to value, as they have different investment attributes. The onset of the COVID-19 pandemic led to an extreme scarcity of growth, which amplified investor focus and attention on growth companies. With the development and distribution of vaccines, growth has broadened to a greater percentage of the overall market. The recovery in economic growth both here and abroad is lifting the fortunes of the companies most debilitated by the pandemic of which many fall into the sectors traditionally characterized as value. The extraordinary levels of fiscal and monetary stimulus will run their course over the balance of this year into next year. We believe investor preference is likely to return to growth, driven by technology shares the closer we get to that point.

**WM:** We are seeing signs that the brisk run of multiple expansion we have seen in technology since 2017-2018 could be coming to an end. While we believe that growth as an investment style has room to run over the long-term, we believe that "growth at a reasonable price" is likely to outperform the "growth at any price" strategy in the near term.

**JD: Technology is often viewed as the primary means to access disruptive and innovative companies. Do you agree with this thinking? If so, why are technology companies consistently at the leading edge of this theme and how do you assess these companies as you evaluate potential holdings for your portfolios?**

**BB:** If a company is not a technology firm or tech-enabled, it is likely falling behind its competitors. Technology is being used to improve efficiencies and reimagine business models across industries at a scale and pace that is leading the disruption.

Technology and innovation underpin many of the holdings in our portfolio. We focus on how these factors impact every company we evaluate as managements seek to drive competitive advantage and durable growth.



**WM:** We agree that the technology industry is home to many of the world's most disruptive and innovative companies. When we attempt to identify disruptive companies, we look for businesses with the following characteristics: large and expanding addressable markets, breakthrough technologies, long-term competitive moats, superior operating models, network effects, and the ability to convert existing profit pools into new long term revenue sources.

**JD:** The technology sector has been home to major trends over the last several years such as cloud computing, software as a service (SaaS), E-Commerce, and cashless transactions. How do your teams balance the greater opportunity set for companies that benefit from these trends versus the potential for their returns to be eroded as newer competitors fight for market share and compete on price?

**BB:** Each of these important trends that you highlighted, Joe, have a common thread in that they are increasing returns to scale for the underlying business models. This favors first mover advantage and aggressive reinvestment to capitalize on that advantage, which leads to the creation of real economic value delivered through the products and services that these companies create for their customers. Competitors will emerge in any fast-growing industry and it is our job to track and identify the best among them.

There are plenty of opportunities and trends to be discovered and we rely on rigorous bottom-up research and continuous monitoring in an ever-changing technology landscape. Two of the questions we frequently ask is who is solving the problem better and what is the duration of growth potential? We adjust our positions to reflect our research conclusions.

**WM:** In technology, a company's competitive moat is indispensable for its long term success. We focus on companies that are willing to disrupt themselves in order to stay on the leading edge of innovation and competitiveness.

For more information, please visit [harborfunds.com](http://harborfunds.com).

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