EQUITY

US Tech Sector: Continued Run-Up or Correction Coming?

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Since the infamous "dot com" meltdown nearly two decades ago, people have tended to question any sort of extended run-up in technology-sector stocks. Stephen Dover, executive vice president and head of equities at Franklin Templeton Investments and chief investment officer, Templeton Emerging Markets, recently recorded a podcast centered on the theme of technology and how investors' might view the sector. In this new podcast, he explains why he thinks the situation today is very different from the dot com meltdown.

Listen to the full "Talking Markets" podcast and hear more from Stephen as he talks about tech-sector investing today.

Here are some highlights:

- Probably the biggest difference in regard to technology today is the idea of disruption—for example, using the Internet to disrupt taxi service, retail or communications. And, tech companies today actually have cash flow and earnings. They don't look greatly overvalued like they did at the height of the tech bubble in the early 2000s because of this.
- Living in a world in which we have a lot of money supply and where we have fairly low interest rates means valuations for earnings streams are worth more than they would have been in the past. That's probably the primary driver for tech stocks.
- Ultimately as an investor, when one is trying to decide whether to stay in stocks for a long period of time, one has to consider how these companies will continue to make money. Very broadly, the way they're going to continue making money is for productivity to increase, and productivity only increases when there's reinvestment.

- A benign market can continue that way for a long time. The US economy has had one of the longest recoveries it has ever had, but the recovery has been very weak following the 2007-2009 global financial crisis. So there is some argument that a weaker recovery can last a longer time.
- Investors are pricing in a very positive environment for stocks, but there are always unexpected events that could occur to change the outlook. And if earnings don't keep up, or if interest rates don't stay low, then there is a possibility of a correction, perhaps even severe correction. That shouldn't really disturb long-term investors.
- In many cases a company's management has been the driver of its success versus its peers. That's really hard for an individual investor to assess, and we spend a lot of time trying to do that.

The full transcript of the podcast follows.

Kristine Hurley: First, for our listeners who don't know, tell us a little bit about yourself?

Stephen Dover: Two things that might be interesting. First of all, I was raised on a ranch that had been homesteaded by my great grandfather in Montana. So people who know me at all probably don't know that as my background and that's been one of the things that has been formative to me. Being a rancher's son and a schoolteacher's son, I have always looked at investment in the sense of, those were the type of people that I'm investing for, and I take that very seriously.

And the other very formative thing for me is I was one of the first Americans to study in China in the very early 80s and at that time, [China] was [considered] Third World. I was ironically studying Marxist economics, which hasn't been all that helpful, but it gave me different perspective. So I think that those two things combined have really been what formed me and kind of put me where I'm at this point.

Kristine Hurley: That's a fascinating foundation and from there, how have you ended up doing what you are today?

Stephen Dover: Well, I have had a circuitous route if you will. I have had the opportunity to live in a lot of different countries. I have traveled—you know, I tell my family I have traveled everywhere, but my daughter informs me no, I haven't been to Antarctica yet. So I haven't been everywhere, but most of the countries I have traveled, I have invested in. Most of my career has been spent outside of the United States building investment offices where we are really focused on local investors; we have developed investment products for the Indian market or the Brazilian market or the Canadian market or the European market. So that's been exciting for me and that's pretty much where I have spent my career the last 30 years.

I think I have had the great opportunity to work with a lot of great investors, many of them with Franklin Templeton. Obviously, [the late] John Templeton comes to mind. And now, working very closely with Mark Mobius. But, probably someone that has really been a model for me, I had the opportunity work with Charlie Johnson who was the CEO [from 1957-2005] and really the formative person who built Franklin Templeton. And one of the things that struck me was when he talked in the early 2000s about mutual funds and the purpose of mutual funds, and that mutual funds have been this phenomenal vehicle.

Kristine Hurley: The US tech sector has been on an incredible run. What's your take?

Stephen Dover: Well, it's interesting. I guess that's the advantage of being a certain age; I have been through this a few times. We have seen big rises in technology, the famous being the tech bubble in the early 2000s, but there was a bubble in 1974, as well, and so it's interesting. It's been very interesting to look at. If someone came to you and said, "Look I have got this great idea, I am going to have a global [online] taxi company." You know, it's these new disruptive ideas, would you say it's a technology company or is it a taxi company? So, I think we are in a different situation than we have been in the past and I think that probably the biggest difference is this disruption and the second difference is that these companies are actually having cash flow and have earnings. And at this point, they don't look greatly overvalued like they did in the tech bubble in early 2000s because there are earnings there as well. So I would say that the early 2000s, if you look back, a lot of those projections were right, but they were based on hope. There were a bunch of companies that actually had no earnings and had no real value. So if I can be slightly technical, I would say that the way that most of us as analysts value companies is we look at a discounted cash flow or we look at discounted dividends and most of those companies in the early 2000s, you couldn't value that way. So you had what was called the terminal value. You presumed that after 20 years it was going to have a whole lot of value and you discounted that back and that was valuation. We are not in that situation at this point, we are really looking at companies that have cash flow or at least have the potential to have cash flow.

And I think probably the real biggest issue with these technology companies is that they are disruptive, that we are having an opportunity to really use the leverage of the Internet to disrupt the taxis, or to disrupt retail, or to disrupt communications and there is a valuation in that one. We'll have to see how it all turns out, but I think that it is different than some of the situations we had been in the past.

Kristine Hurley: So with the disruption, do you think that also changes the timeline of these [market] rallies? We have seen the steep run-ups previously, as you have mentioned, but this seems to have gone on for an extended period of time. Do you attribute that to the disruption or what do you attribute that to?

Stephen Dover: Well, with technology stocks, we are really looking at a different industry and we are looking at different opportunities and we are looking at monopoly power to some degree. So what do you disrupt? You disrupt areas that have high profit margins and that's really where these companies have gone, and so there's just by definition a lot of opportunity there. But I think your question is probably a little more broadly about the market. When you are looking at valuations in the market, I think a way to look at it and a way to think about valuations, rich or not rich, is to think that P/E ratios are really, think of them as an inversion that they're very similar to interest rates and that when you have low interest rates something in the future is worth more because it's discounted at a lower interest rate. And because of that, you can't really compare current valuations to past valuations. So living in a world in which we have a lot of money supply, in which we have fairly low interest rates and even interest-rate projections to rise are pretty benign, that means that valuations for earnings streams are worth more than they would have been worth in the past, so that is probably the primary driver behind why markets have performed. Also, when you have very low interest rates, but you have higher earnings streams, buybacks are worth more than dividends and that's been a big part of the market as well. The markets actually shrunk. There are fewer shares, fewer companies in the market than there have been over the last say 20 years and despite IPOs and new companies and that's because of all of these buybacks that have happened.

And then I would say the third thing is really the political environment. We are in an environment that is generally very positive for business and if anything, it looks like there's more upside, for example potential tax cuts, than there is downside. So it's a pretty benign environment and that's the situation where you end up having markets at all-time highs.

Kristine Hurley: From an earnings perspective, we have come through part of the earnings season and we are seeing continued strong earnings. We have seen those buybacks continue, if we do have this benign interest-rate environment, would you expect that type of situation to continue from buybacks and what we are seeing on balance sheets?

Stephen Dover: There doesn't seem to be any slowdown in the buybacks. Now, the disappointment with buybacks and what you would hope to have in an economy would be that companies would be reinvesting. That's an area where we haven't seen as much reinvestment back into the economy as we would like. And I would say part of that is public policy issues as much as literally business issues and we haven't seen the increases in productivity. So ultimately as an investor, when you are trying to make a decision about whether you should stay in stocks for long period of time, how are you going to make money? Well, the only way those companies, I am talking very broadly now, are going to make money is if the productivity increases and productivity only increases when there's reinvestment. So that's part of what we have to take into the outlook.

Kristine Hurley: And with that outlook if we do have this benign environment continue and it's prolonged, how long do you think the rally can last or are we vulnerable to sector unwinds and a pullback in the sector?

Stephen Dover: We have to look at what has happened in this market. There's been rotation in the sense that there have been sectors that have performed very well, most notably the technology sector, and sectors that have had terrible rollovers, such as the energy sector, and at different times the health [care] sector and some of the other sectors. So that's healthy for a market. You don't see that on the top number of how the market performs, but you see it underneath in terms of rolling. A benign market can happen for a long time. In this particular economy, in the United States at least, we have had one of the longest recoveries that we have ever had, but we have also had a weaker recovery than we have ever had, too. So there is some argument that a weaker recovery can last a longer time than a strong economy.

But, maybe another way to look at your question is what can throw us off or what could cause a correction and I think that there are several things. You know, the big thing and it's an odd answer, but it's what we don't know, right? There could be a political situation, it could be a terrible situation in Korea, it could be trade war with China, it could be a political incidents in the United States, because investors are pricing in, if you will, a very positive environment. So if it doesn't—if earnings don't keep going, if interest rates don't stay low, then there's a possibility that there could be, at a minimum, a correction or perhaps a severe correction. So those are unpredictable, but I would say that the likelihood of a correction over the course of the next couple of years is probable and that shouldn't really disturb long-term investors.

I think that most investors should look at their investments in two ways, of course whatever their portfolio is. But for most people, particularly people that are younger, the biggest part of their portfolio is actually their earnings streams, their savings over a period of time. When you take that into account, it changes the risk profile of how you should invest and I'm saying that because that implies, what you do when you are at the top of the market?

So I recall a very famous saying John Templeton had at a conference [where] somebody said to John Templeton, "Sir John, I have just inherited some money. It's all in cash and I want to invest, when should I invest?" And his response was, "You should invest when you have the money." So I think that I certainly would not want to chase the market at this point and I certainly wouldn't want to chase those more expensive stocks at this point. But where people make their mistakes, if there's one mistake the typical retail investor makes, is trying to time the market and get in and out of the market. So it's probably not a good time to rush into the market, but I would be very careful about getting out of the market at this point.

Kristine Hurley: You hear so much about this mentality, of this "rally has continued, our stock is at a peak, I need to get out now, do I take profit or do I get out before it continues" and so I guess your take on that mentality would be….

Stephen Dover: I think we live in a world in which there's so much information and there are so much more data than there ever was in the past and as analysts we are trying to figure out how you sort all of that out. You've got people screaming at you on TV about buy or sell, or whatever, and the real challenge now, I think, for investors is to be dispassionate, to actually, you know, maybe turn that stuff off and turn the volume down. And we, as a company, still highly value visiting the companies, knowing the management, trying to look at things strategically. As I have been in this industry for a long period of time, I realize it's those qualitative factors of really being there and kicking the tires and meeting the management that is really what is incredibly helpful in [determining] where these companies go.

If you look at technology companies, of course they have to have the technology, but in many cases it's really the management of the company that has determined whether one of these companies is more successful than the other. That's really hard for an individual to assess and that's really what we try to do we spend an awful lot of time on that.

Kristine Hurley: Let's talk about valuations. It seems asset prices are high across the board. Do you agree with the statement that almost nothing can be bought below intrinsic value, there are very few bargains and is it a world where the best we can do is look for things that are less overpriced than others?

Stephen Dover: I think one of the problems with modern investing and the way that we look at investing is it's a relative world rather than an absolute world. I think trying to beat the benchmark all the time or even looking and evaluating your manager based on that is sort of a short-term way of looking at things. And that, in essence, probably what happened with the big movement in passive investment. The markets are at an all-time high, there just aren't as many opportunities out there as there have been. That doesn't mean the markets not going to go [up] more, we could have been talking a year ago when the market was also at a high or had a lot of appreciation. I think there are fewer opportunities out there than there were in the past. I would encourage investors to look outside of the United States. I think the United States relative to other countries is more highly valued—just a quick statistic or a number on that, I manage global funds and when I was managing say 10 years ago, the United States accounted for about 40% of the world's market value. Now it accounts for about 54% of the world's market value.[1] So just on a relative basis do you think the US is going to be 60% of the world's market cap and at some point? You have to say, okay, maybe there are some opportunities in some of these other countries. We are talking about technology; there are opportunities in the emerging markets with technology stocks and companies that are innovative and hitting gargantuan markets, primarily China. I think people tend to look at what they are familiar with and that's why you need some help, I think, in guidance and advice, but there are an awful lot of opportunities outside the United States.

Kristine Hurley: Can you talk a little more about that? What is your outlook for the emerging-market tech sector?

Stephen Dover: One of the things I would like to say about emerging markets, back in the old days in the 80s when I started, they were called "Third-World" countries, you know, and they were in an area that was almost banned for most mutual funds. And nobody wanted to invest in them because they were too risky. I think that emerging markets are appropriately termed emerging markets because they are emerging, they are changing. They were countries that were poor, they had cheap labor and they were primarily building themselves. On exports—exports are still very important—resources, countries like Brazil that have huge deposits of iron ore, for example, and oil and that was what drove it. The growth in China, particularly, drove the growth in these other emerging markets, but we are at a tipping point where resources and exports are now a smaller part, of the market cap of emerging markets. And emerging markets, I think this is surprising and I don't think that most people know this, but emerging markets have a higher technology content to their benchmark, to their index [MSCI Emerging Markets Index[2]], than almost any other broad index that we have.

Kristine Hurley: Do you see that being an area that has maybe a longer runway than the US in terms of tech-sector rally; is it earlier in its infancy?

Stephen Dover: It's earlier in its infancy and it's a different kind of disruption because these countries haven't built the foundations or don't have the history of the United States. They leapfrog things that happened in the United States. I think probably, to me, the most classic example of that is the mobile phone. So when you look at a country like India, in the United States, obviously we had telephones in our houses and now we have mobile phones. In India, they jumped immediately to mobile devices. Only half of the Indian population or so uses banks. They immediately jumped to mobile banking. So I don't know if disruption is a right word, but there is a leap there and an increase in potential productivity that is hard to have in developed countries.

Kristine Hurley: Sounds like there are a lot of opportunities that do exist in that area. Are there also maybe challenges in certain, either governmental or societal issues that might make that challenging?

Stephen Dover: Oh my, that's been my whole career. These countries are always having challenges and that's what scares people off, right? And they are tough to travel to. I mean, I have traveled through the Middle East and through the heat and been at these meetings and you are talking with companies. If you really want to know what's going on and you have a translator and you have to have really, some persistence to try to really figure out the companies and what's going on. But that's why there are greater opportunities, because they are just not as efficient. The markets are not as efficient, even close to as efficient, as the developed markets and there's more opportunity for growth. Of course, there are more risks—there's government. I've followed Brazil now for 30 years, and there's a saying in Brazil: "Brazil is the country of the future and always will be," because it's never quite getting there. But, wow, what a rich country, and when I say that in terms of opportunity and growth and intelligent people. But it's very volatile and has a lot of political problems and you have to really stay on top of that. It's risky; it's hard to know what's going on. If I could say as an example, most of the ETFs for emerging markets are highly concentrated in a few stocks that are mostly the exporters. So, as I said before, these countries are changing dramatically and if you were positive on Brazil, you would want something that probably reflects the growth in Brazil and reflects the economy and the only way to do that is to really find an active manager that understands that and invests in that way.

Kristine Hurley: I'm sure you have some great travel stories from along the road…

Stephen Dover: Yes, I do.

Kristine Hurley: And with that, though, I'm sure it offers a unique perspective that you need. You said it's challenging to invest in some of these areas. I'm sure it's equally, if not more challenging, to uncover the opportunities and do the research. Do you think the ability to travel and having teams travel or be located throughout the globe may offer a unique perspective or help in uncovering opportunities?

Stephen Dover: I have been blessed. I have spent most of the last 30 years traveling and I pretty much go everywhere and I think that has given me an opportunity to have a different perspective. But part of my perspective is that I know I don't know all that much, despite all that travel. There's no comparison between what I know and what a local knows and I am very clear having lived in many of these different countries that you have to speak the language, that it makes a really big difference to shop in the stores and to have a local network. I think that's one of the things I'm quite proud of is that we, as a company, have really built all these local connections. And so, I think my knowledge of the market, or our knowledge of the market, is so greatly enhanced by being in Vietnam, or being in Germany, or being in the UK or all these different places. It doesn't mean you can't get on the airplane in San Francisco and manage everything from there, but it's very different and it's particularly very different if you want to get beyond the large-cap stocks.

Kristine Hurley: So how do you look under the hood? How do you get access to the management and have those conversations?

Stephen Dover: A typical analyst at Franklin Templeton covers somewhere around 20 stocks. So that would mean that you are spending two weeks, 80 hours just studying a particular stock and I think that's what it takes. And remember, that's cumulative knowledge, so they are actually not just learning from nothing, they are actually adding to what they have known in the past. That's what it takes to really understand the stock, to understand the management and to understand the strategy and that is an analyst. On top of that is a portfolio manager who questions that analyst and tries to figure out whether that stock should fit in the portfolio or not. So that's what it takes to understand, in my opinion, to really understand the company.

Kristine Hurley: At the start of the conversation, you laid out why this rally does look different than some past run-ups in the tech sectors, specifically the dot com era. While there are some differences, do you think a pullback or some sort of correction in the market would also be different than we have experienced in past cycles?

Stephen Dover: It's hard to say. I mean, that's always the big surprise. It would surprise me if we didn't have a 5% or 10% pullback; that's the history of the markets and markets get ahead of themselves. I think it would probably be healthy for the market. I think the real question is would there be a meltdown or would there be a huge correction. That's very hard to predict. Earnings are a big protection against a big meltdown and even if you look at technology stocks on a P/E ratio, they are sort of at 18-19 P/E ratio now.[3] They have decent returns on equity as opposed to 2000 where they had P/E's of 50 or 100.[4] There still are some of those out there, and they would be at risk.

To me, the biggest risk is what we really don't understand and one of the things I certainly don't understand, but I haven't really found experts that understand so well either, is what is the implication of this monetary policy experiment that we have had over the last 10 years or so and what is the endgame with that. How does that become unwrapped? I have listened to a lot of economists, and I am certainly listening to the central banks and we are in uncharted territory on that and how that unwinds is going to have effect on the markets. And we don't know exactly what the effect is, but I would hold that in the back of my mind if I was a reader. If you are interested in that, I would read broadly on that. There's always people out there trying to scare you, but that would be something worth understanding from a macroeconomic point of view.

Kristine Hurley: You said if we see a slight pullback, it could be considered healthy. You hear these market pundits, these TV shows talk about buying on the dip. Do you think the fundamentals support the sector where if we had a slight pullback, it would be an opportunity to either put more money in or reinvest or stay invested or does that go back to mentality of long-term versus short-term?

Stephen Dover: I have never understood buying on the dip and the reason I don't understand it is because it presumes that you are just sitting there in cash. So if you look at the market over a period of time, you would never make money buying on the dip because by definition in cash and missing the upward movement on the market. I personally think that the best thing is to look at your objectives and look at where you want to be in three or five years and really focus on that and then make adjustments to that. It's a strategic movement and I think almost all the academic and all of the experience at least that I have had over time is that's a much more likely way for you to meet your financial goals than to try to wait and buy on the dip. People who have been holding cash for the last five years, waiting for dip haven't done very well.

Kristine Hurley: Anything that we haven't covered that you would like to highlight or touch on?

Stephen Dover: Well, I think this has been an interesting interview for me. I hope it's been interesting for our listeners I think that what I would like to say is we are in a really exciting time. We talked a lot about technology and this disruption or these changes in the world, what I have seen is the tremendous growth and the opportunities in these emerging markets and people that were really living on the edge of poverty and are now growing. So it's exciting to me to see what's happening and how the marketplace is actually providing wealth for the world as a whole and I think that's going to continue in the future, and that's really what we are talking about when we are talking about investing in the equity market. I think that if there's something that I would try to convey, it's a great book I read called *The Signal and the Noise,* but it's really the point that we live in a world where we have so much information and it's very easy to get distracted and the real challenge of us, as investors, is to find that signal with all the noise that we have. If we were to look back 30 years ago and we were to know all this amazing information we have about companies, you would think we would be, it would be phenomenal and in many ways it is, but it also makes it more difficult because there's more noise. So that's our job; that's what we are trying to do at Franklin Templeton is really be quiet and try to sort out the signal from the noise.

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1. Source: MSCI. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. See www.franklintempletondatasources.com for additional data provider information.

2. The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging-market countries. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. See www.franklintempletondatasources.com for additional data provider information.

3. Source: Bloomberg LP, based on S&P 500 Information Technology Index forward and trailing price-to-earnings (P/E) ratios. The P/E ratio is a valuation multiple defined as market price per share divided by annual earnings per share. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges See www.franklintempletondatasources.com for additional data provider information.

4. Ibid.

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