

## Remain Overweight Tech Sector, but Pick Your Spots

### Summary

Tech's strong performance, expensive valuations, and robust 27% S&P 500 weighting are raising yellow flags. Investors are justifiably questioning Tech's future returns and if they should decrease their portfolios' Tech exposure. The broad market faces increased concentration risk due to Tech's hefty market weighting. If Tech stumbles, the stock market will feel the impact. This Strategy Snapshot dives into the Tech sector, with a specific focus on valuation, technicals, and fundamentals. It ends by offering actionable opportunities within Tech and providing single name ideas using quantitative growth, value, quality, and income screens.

In our view, the takeaway is clear. Tech is a winner, and it should command a premium valuation. The sector's sales growth and profit margins consistently outpace the broad market. From a thematic perspective, Tech represents the foundation of tomorrow: cloud computing, industrial automation, the Internet of Things, 5G, cybersecurity, and increased ad spending. Despite Tech's yellow flags, we remain firmly OW the Tech sector. However, we caution investors against aggressively overweighting Tech. Valuations are stretched after the recent rally, and reversion to the mean suggests high flying Tech stocks could have the most to fall.

### Main Points

- ▶ Tech Y/Y relative return vs the S&P 500 is approaching +2std, which suggests muted future returns (**Figure 1**).
- ▶ Tech makes up more than 25% of the S&P 500's sector exposure and keeps getting bigger (**Figure 2**).
- ▶ The Big 5 would be the 17th largest country based on their 2019 revenues and nearly 50% of the size of Italy and Brazil (**Figure 3**).
- ▶ Investor sentiment may be overly optimistic, but it is nowhere near as speculative as the late 1990s Tech rally (**Figure 4**).
- ▶ Tech's sales growth & profit margins consistently outpace the Russell 3000 Index, supporting a premium valuation (**Figures 5 & 6**).
- ▶ The growth in software spending far outpaced spending on hardware & semiconductors from 2000-2018 (**Figure 8**).
- ▶ Use dividend growth Tech sector ETFs to gain Tech exposure & generate income (**Figure 9**).



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### U.S. Sector Ratings

12-18 Month Investment Horizon

Sector	Our View	Last Chg
Comm Svcs	OW	Dec-19
<b>Tech</b>	<b>OW</b>	<b>Dec-19</b>
Health Care	OW	Dec-19
Cons Disc	N	Dec-19
Energy	N	Dec-19
Real Estate	N	Dec-19
Industrials	N	Dec-19
Utilities	N	Jul-20
Financials	UW	Jul-20
Materials	UW	Dec-19
Cons Stpls	UW	Dec-19

Source: MarketDesk Research

### Tech Industries

See page 4

Industry	Factor Tilt
Data Processing	GARP
Electronic Component	-
Hardware	Value
I.T. Services	Value
Internet Software	Growth
Semiconductors	GARP
Software	Growth
Telecom Equipment	Quality

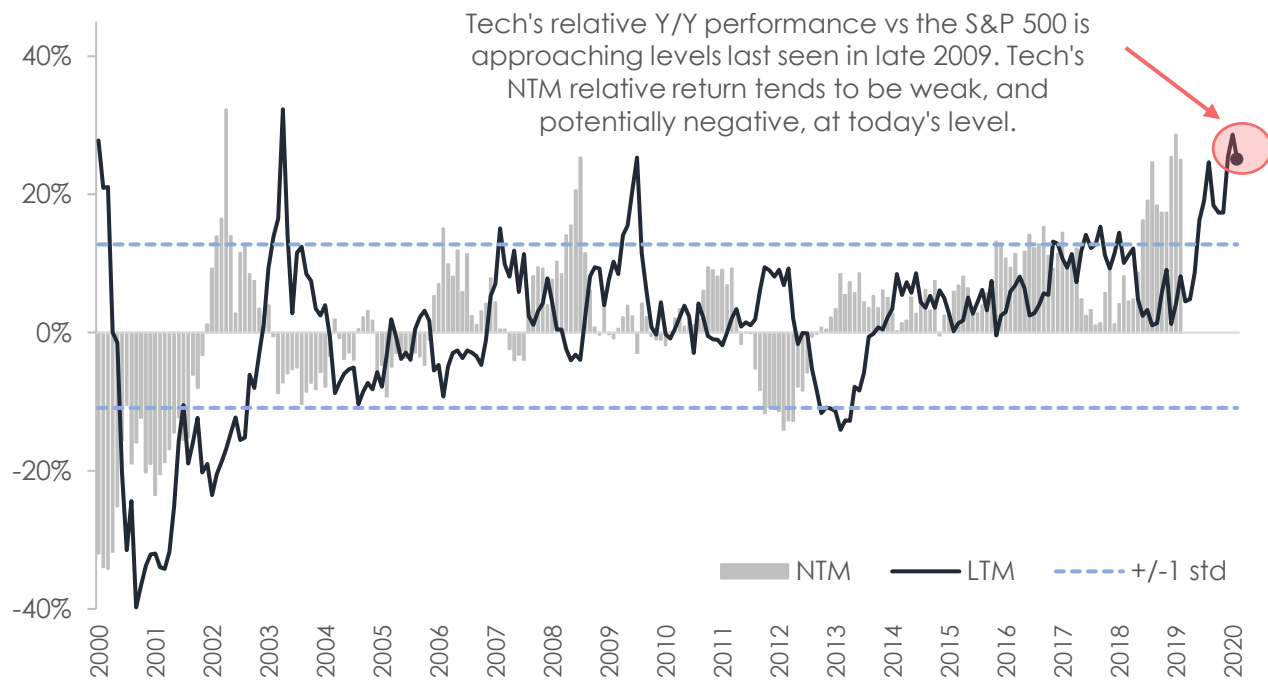
Source: MarketDesk Research

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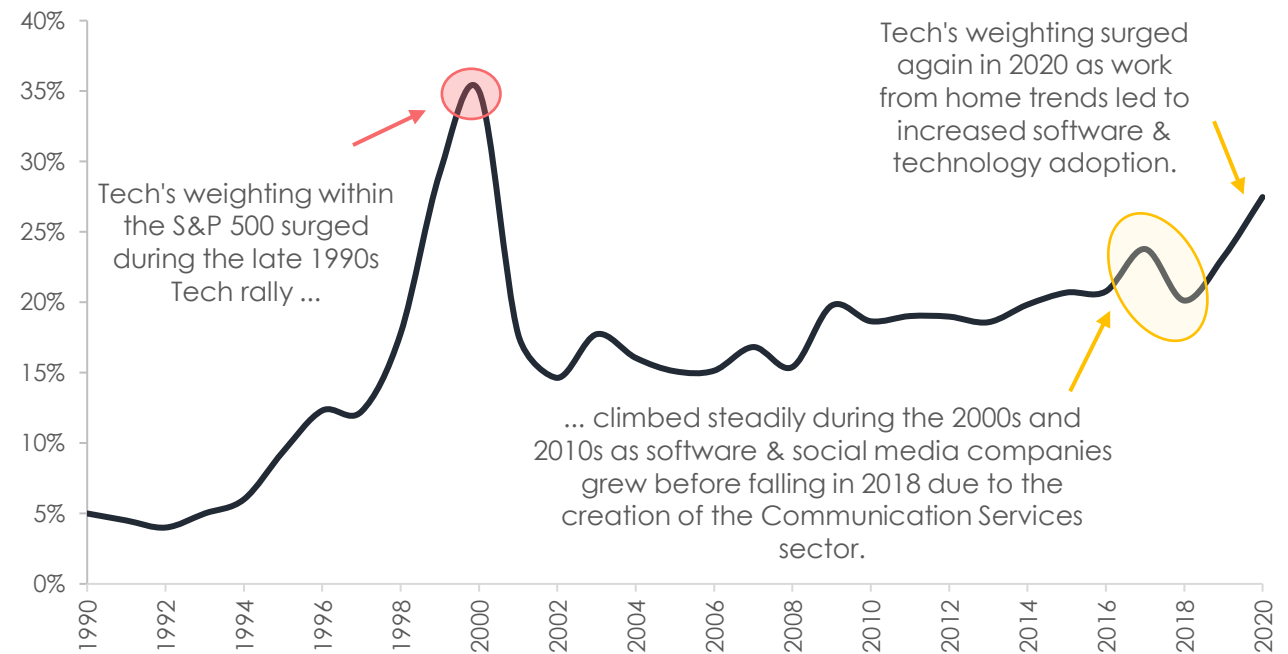
## Tech's LTM Return, S&P 500 Weighting, & The Size of the 'Big 5' Raise Yellow Flags

FIGURE 1: Y/Y Relative Return — Tech vs S&P 500



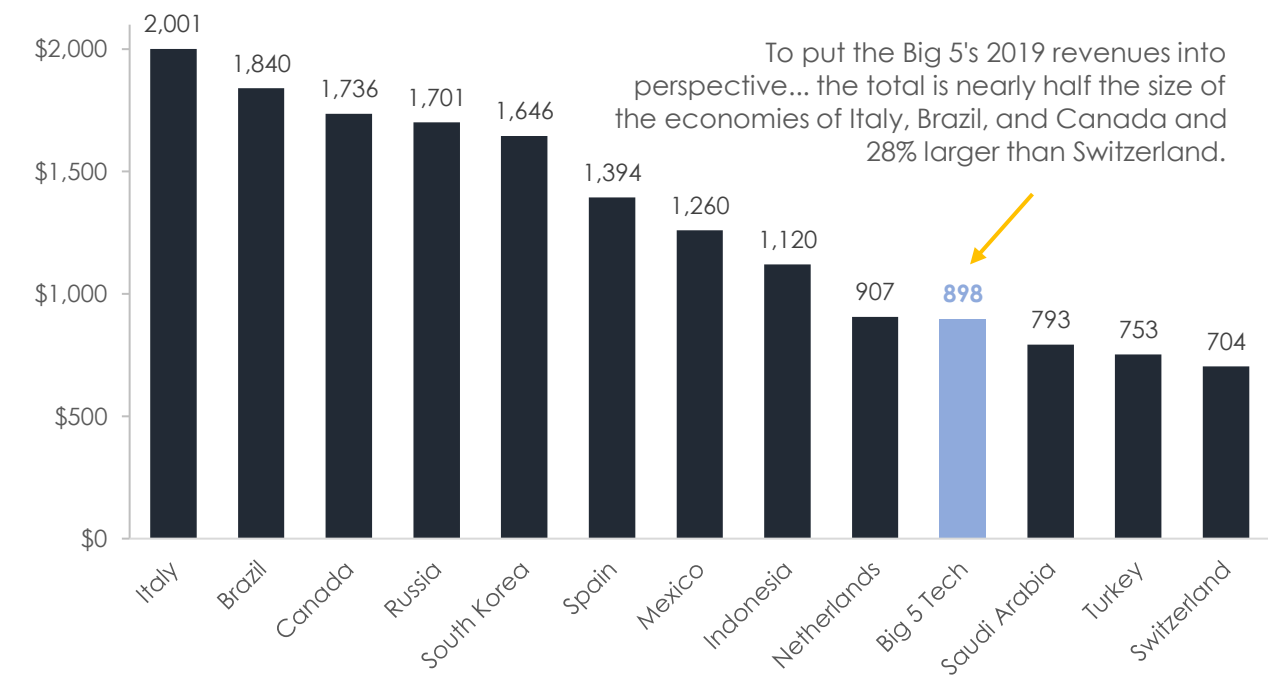
Source: MarketDesk Research

FIGURE 2: Tech Sector Weight within S&P 500 Continues to Grow



Source: MarketDesk Research

FIGURE 3: Ranking Big 5 Tech's 2019 Revenues vs Country GDP



Source: MarketDesk Research

Figure 1: Tech's Recent Returns vs S&P 500 Indicate Muted Future Returns ...

- Tech's y/y rolling return vs the S&P 500 is nearly +2std above the 20-year historical average. For an approximately normal dataset, ~95% of the values would be expected to fall within +/-2std.
- Historical returns suggest limited future returns when Tech approaches +2std, such as in 4Q 2003 and 4Q 2009. Reversion to the mean is a powerful market force.

Figure 2: Tech Now Influences More of the S&P 500's Return ...

- Tech makes up ~27% of the S&P 500. Tech's increased weight within the S&P 500 reflects changes within the broader economy and highlights Tech's maturity.
- Tech's towering market presence creates concentration risk not only for the sector but also the broad market. Investors are rightfully concerned a Tech sell off could lead to a broad market sell off.

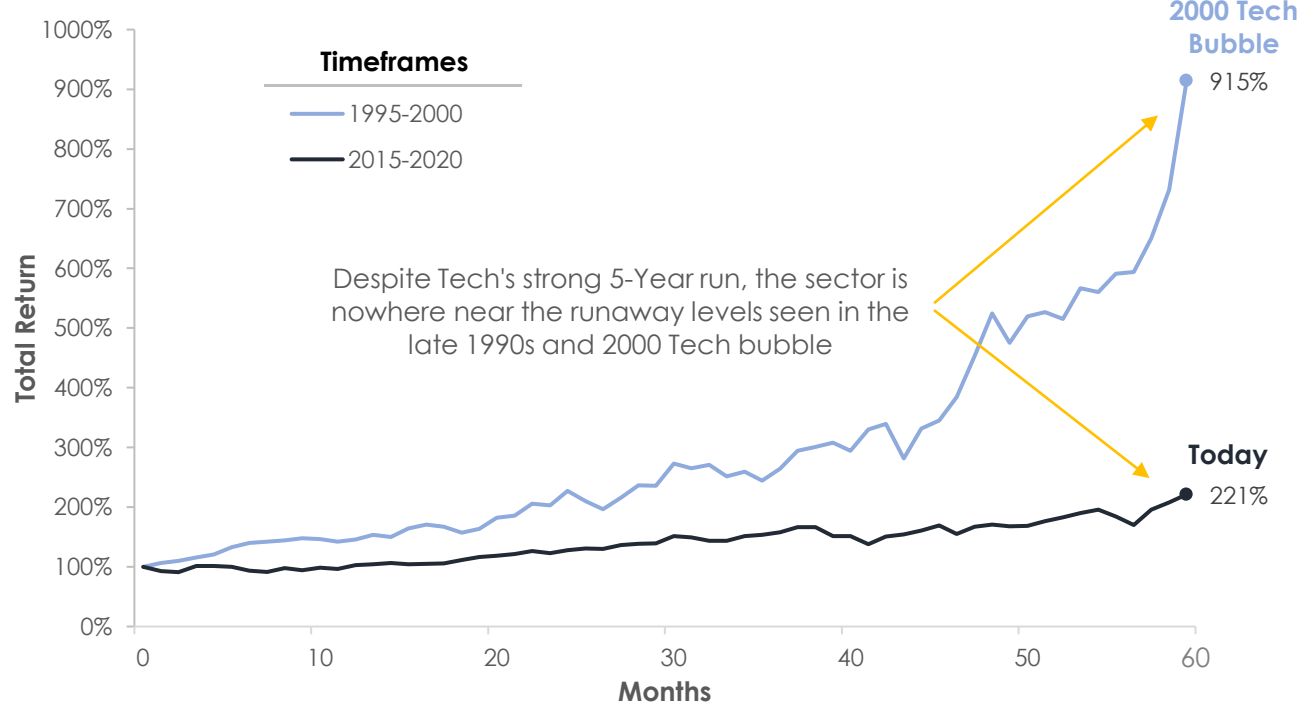
Figure 3: ... Due to the Above Average Growth of the 'Big 5'

- There is growing concern about the 'Big 5', which includes AMZN, AAPL, GOOG, MSFT, and FB, and their hefty market caps. AMZN, AAPL, and MSFT each trade above \$1.5Tn market cap. GOOG is slightly under the threshold at \$995Bn.
- The 'Big 5' generated a combined \$898Bn in 2019 revenue. The massive 2019 revenue haul makes the 'Big 5' the 17th largest country, slightly smaller than the Netherlands but bigger than Saudi Arabia.



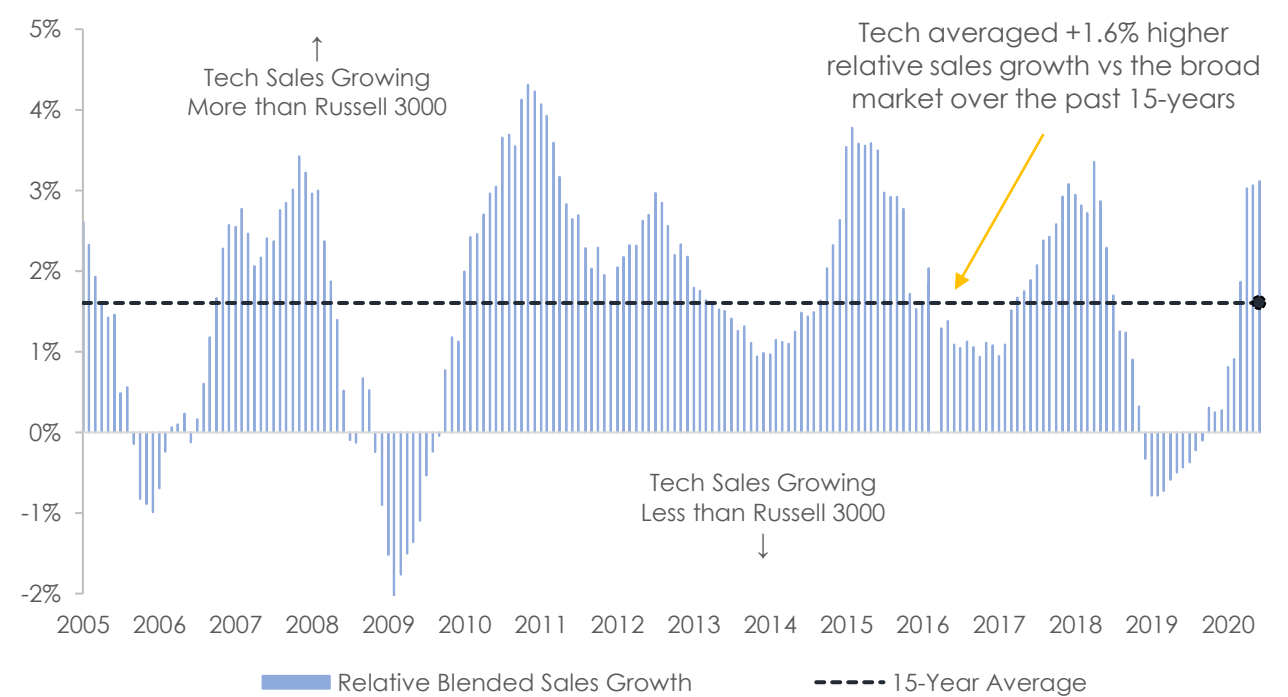
## Putting Tech's Rally into Perspective & Looking at the Fundamentals

**FIGURE 4: Nasdaq 100 Index 5-Year Return Comparison — Past 5 Years vs Late 1990s**



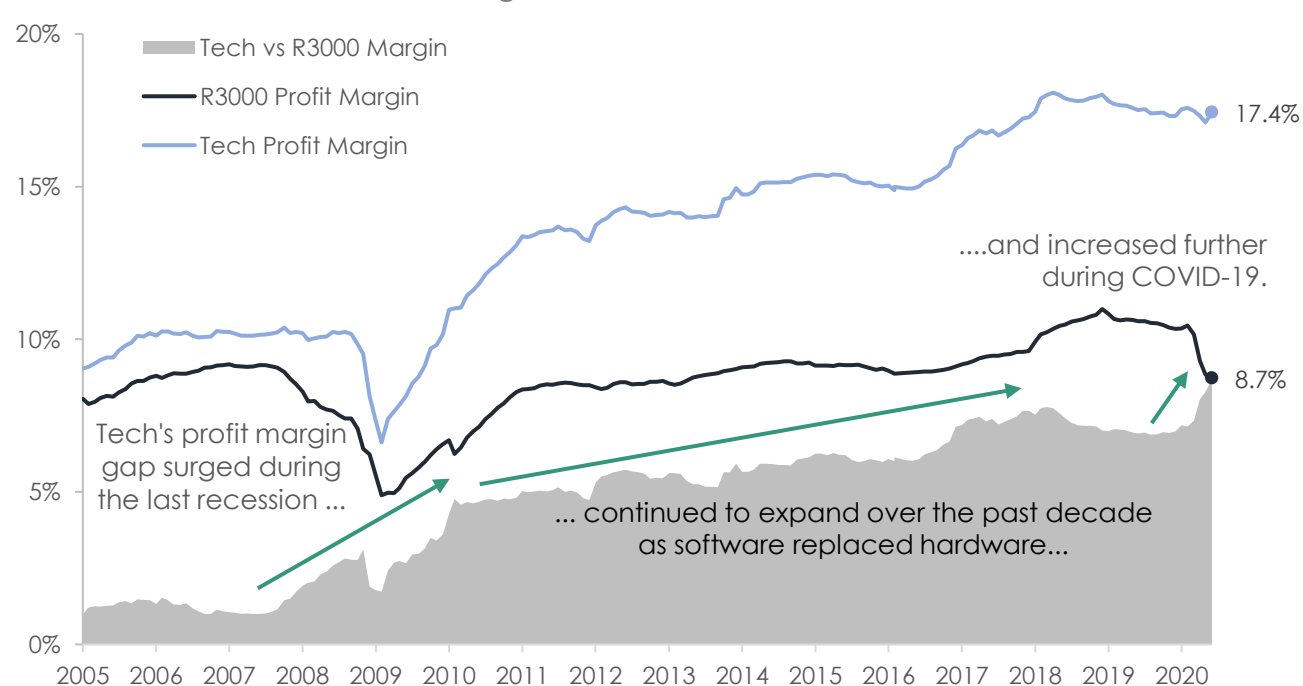
Source: MarketDesk Research. **Note:** Lines represent 5-Year cumulative returns.

**FIGURE 5: Tech's Blended Sales Growth vs Russell 3000**



Source: MarketDesk Research. **Note:** Blended Sales Growth is the average of LTM & NTM.

**FIGURE 6: Tech's Blended Profit Margin vs Russell 3000**



Source: MarketDesk Research. **Note:** Blended Profit Margin is the average of LTM & NTM.

**Figure 4: Current Tech Rally Less Speculative than Late 1990s Rally ...**

- This current Tech rally draws many comparisons to the late 1990s rally. However, the comparisons appear overdone when comparing Tech's returns over the two periods.
- The Nasdaq 100 Index returned 121% the past 5 years vs 815% over the 5-year period from 1995 to 1999. Investor sentiment toward Tech may be overly optimistic today, but it is not close to the irrational levels experienced in the late 1990s.

**Figure 5: Tech's Sales Growth Consistently Outpaces the Broad Market ...**

- Growth is in high demand amid a low growth environment, and Tech's blended sales growth continues to exceed the Russell 3000. Valuations are high, but winners generally command a higher premium.
- We expect Tech's sales growth outperformance to continue. Tech sits at the convergence of multiple trends: cybersecurity, cloud computing, industrial automation, 5G, and increased ad spending. Investors need Tech exposure.

**Figure 6: And Tech's Blended Profit Margin Advantage Grew During the Pandemic**

- Tech's blended profit margin grew ~80% from 1Q 2005 through 2Q 2020, while the Russell 3000 Index's profit margin grew ~14%. The gap widened during the pandemic as Tech's profit margin held steady and the Russell 3000's profit margin contracted.
- We attribute the margin expansion to increasing software exposure and decreasing hardware exposure. Software businesses tend to be less capital intensive.

## Finding Active Opportunities in Tech — Focus on Software & Dividends

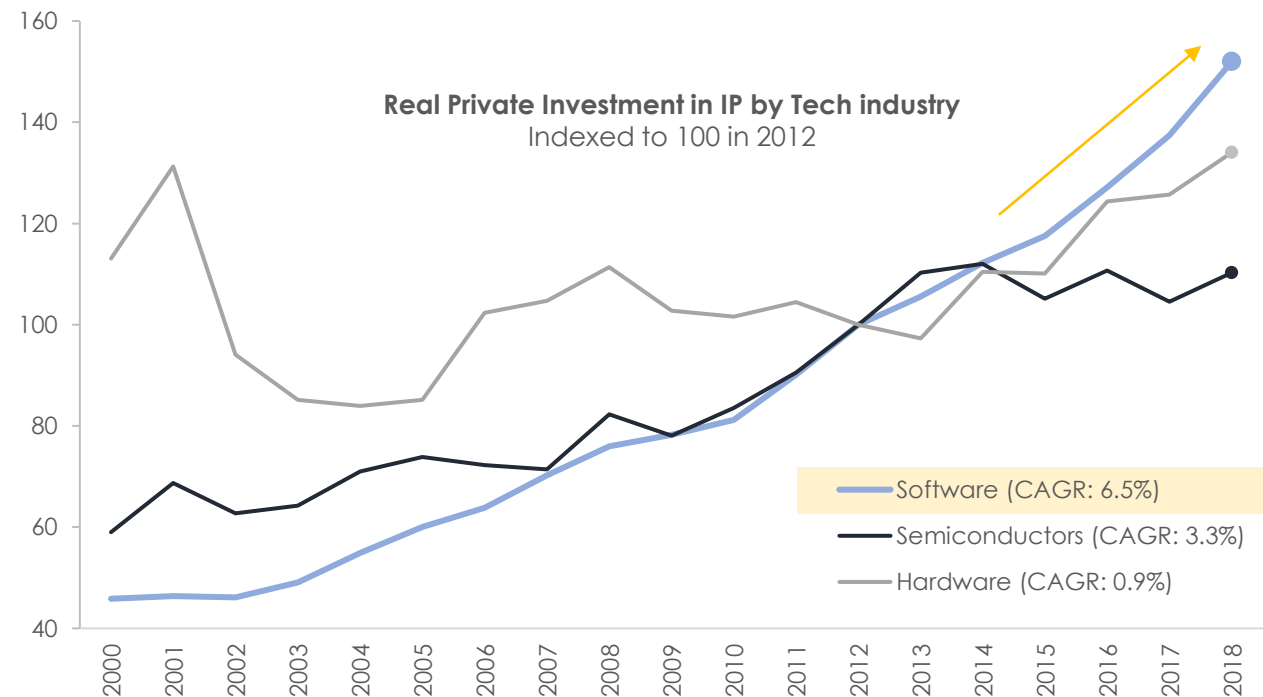
FIGURE 7: Tech Industry Fundamentals

Sector / Industry	Valuation Composite <sup>1</sup>	Sales Growth <sup>2</sup>	EPS Growth <sup>2</sup>	PEG Ratio	ROIC
<b>Tech Sector Average</b>	2.9x	4%	6%	1.7x	17%
Hardware	-0.2x	-3%	-2%	4.4x	13%
Electronic Components	1.8x	0%	-2%	2.4x	6%
Telecom Equipment	3.4x	6%	8%	1.8x	28%
Data Processing Services	1.9x	7%	10%	1.2x	3%
Internet Software	2.0x	14%	8%	2.0x	14%
Semiconductors	2.3x	3%	0%	1.4x	12%
I.T. Services	1.1x	3%	2%	1.7x	13%
Software	2.7x	10%	21%	2.6x	12%

<sup>1</sup> Valuation Composite is the average Z-Score of LTM P/E, NTM P/E, P/B, EV/Sales, EV/EBITDA using the last 5-years of data. <sup>2</sup> Sales Growth and Blended EPS Growth are the average of LTM results and NTM estimates. **Note:** The color blue (red) highlights the highest (lowest) value for each column among industries.

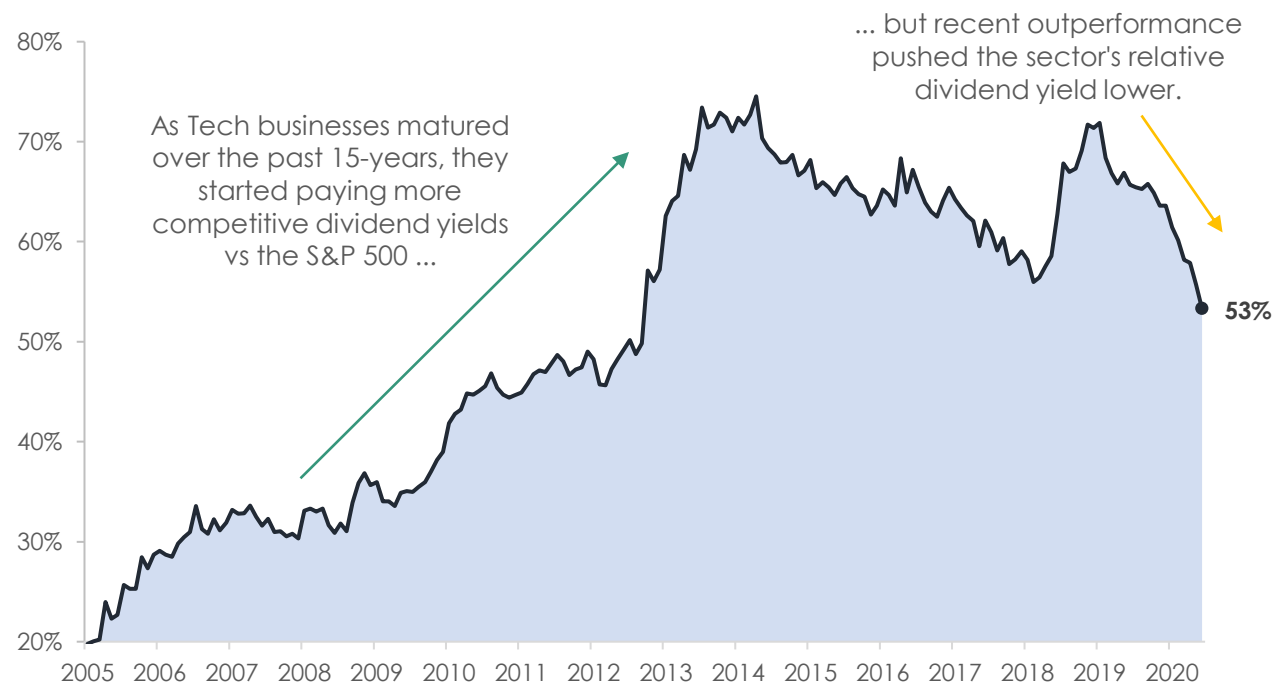
Source: MarketDesk Research

FIGURE 8: Software & Data Processing Industries Primed for Continued Growth



Source: MarketDesk Research, Bureau of Economic Analysis

FIGURE 9: Relative Dividend Yield — Vanguard Tech (VGT) vs S&P 500 (SPY)



Source: MarketDesk Research

Figure 7: Tech is More Than Just the 'Big 5' ...

- Industry Quick Hits: Value - IT Services; Growth - Software; Growth at Reasonable Price (PEG) - Data Processing, Semiconductor; Quality (ROIC) - Telecom Equip

Figure 8: Software Remains a Focus Investment for Companies ...

- Data tracking private fixed investment in intellectual property from 2000 through 2018 shows where companies are spending on technology. Software investment grew at a 6.5% CAGR compared to semiconductors' 3.3% and hardware's 0.9% CAGRs.
- We believe software will continue to be an area of focused spending. There are three software focused ETFs: IGW, PSJ, & XSW. PSJ is the most concentrated with 30 holdings. IGW is more diversified than PSJ and weighted toward large caps. XSW is the most diversified, employs an equal weighted approach (e.g. fewer large caps), and includes data processing companies. Our preference is XSW, followed by IGW.

Figure 9: Tech Sector Exposure with a Focus on Dividends to Generate Income ...

- Tech is not historically a high dividend paying sector compared to the S&P 500. However, the relative dividend yield gap closed as Tech matured over the past 15 years.
- Investors looking for Tech sector opportunities should consider dividend focused Tech ETFs. There are two ETFs: TDIV & TDV. TDV focuses on consistent dividend growth over the past 7 years and is equal weighted, while TDIV only requires a yield above 0.5% and no decrease in the past 12 months. Our preference is TDV over TDIV.



## Quantitative Opportunities Beyond the 'Big 5' – Growth, Value, Income, & Quality

### Long-Term Growth Companies

Companies with Long-term Growth Rates Above the Tech Sector's Average

Ticker	Company	Market Cap \$Bn	Dividend Yield	NTM P/E	Earnings LTG
LRCX	Lam Research Corporation	51.8	1.3%	19.8x	19.2%
CACI	CACI International Inc Class A	5.1	0.0%	14.5x	14.1%
ROP	Roper Technologies, Inc.	43.4	0.5%	32.8x	12.7%
CSGP	CoStar Group, Inc.	27.6	0.0%	67.2x	11.1%
ADBE	Adobe Inc.	213.1	0.0%	41.8x	11.1%
KLAC	KLA Corporation	31.6	1.7%	19.7x	10.7%
FFIV	F5 Networks, Inc.	9.4	0.0%	16.2x	9.4%
ANET	Arista Networks, Inc.	17.3	0.0%	25.2x	9.2%
NVDA	NVIDIA Corporation	254.1	0.2%	46.1x	9.2%
INTU	Intuit Inc.	77.7	0.7%	37.0x	9.1%
<b>Sector Average</b>		<b>111.8</b>	<b>1.0%</b>	<b>26.1x</b>	<b>4.3%</b>

Source: MarketDesk Research. **Earnings Long-Term Growth Rate** is the average of the next twelve months growth and second next twelve months growth.

### Companies Trading at Discount to Long-Term Valuation Average

Companies Ranked Based on How They Trade vs Their Historical Valuation Levels

Ticker	Company	Market Cap \$Bn	Dividend Yield	NTM P/E	Valuation Composite
MANT	ManTech International Corporat	1.8	1.9%	22.9x	-1.4
DOX	Amdocs Limited	7.9	2.2%	12.8x	-1.4
NATI	National Instruments Corporator	4.9	2.7%	31.2x	-1.2
WDAY	Workday, Inc. Class A	32.8	0.0%	76.0x	-1.2
CARG	CarGurus, Inc. Class A	2.3	0.0%	44.1x	-1.1
CACI	CACI International Inc Class A	5.1	0.0%	14.5x	-1.1
FLIR	FLIR Systems, Inc.	5.4	1.6%	18.8x	-1.0
AZPN	Aspen Technology, Inc.	6.6	0.0%	26.5x	-0.9
ANET	Arista Networks, Inc.	17.3	0.0%	25.2x	-0.7
EVBG	Everbridge, Inc.	4.8	0.0%	-	-0.5
<b>Sector Average</b>		<b>111.8</b>	<b>1.0%</b>	<b>26.1x</b>	<b>+1.2</b>

Source: MarketDesk Research. **Valuation Composite** is average Z-Score of NTM P/E and EV/EBITDA.

### High-Quality Companies

Companies Assigned Quality Scores Based on Key Balance Sheet & Income Statement Metrics

Ticker	Company	Market Cap \$Bn	Dividend Yield	NTM P/E	Quality Rank
EBAY	eBay Inc.	39.8	1.1%	15.5x	9.0
ROK	Rockwell Automation, Inc.	26.3	1.8%	29.6x	9.0
ALLE	Allegion PLC	10.1	1.2%	25.5x	9.0
FICO	Fair Isaac Corporation	12.1	0.0%	46.8x	9.0
V	Visa Inc. Class A	331.5	0.6%	34.4x	8.8
INTC	Intel Corporation	257.0	2.2%	12.6x	8.6
PAYX	Paychex, Inc.	26.3	3.4%	26.3x	8.6
VRSK	Verisk Analytics Inc	29.3	0.6%	35.8x	8.4
NVDA	NVIDIA Corporation	254.1	0.2%	46.1x	8.4
AMAT	Applied Materials, Inc.	58.5	1.4%	15.4x	8.4
<b>Sector Average</b>		<b>111.8</b>	<b>1.0%</b>	<b>26.1x</b>	<b>5.0</b>

Source: MarketDesk Research. **Quality** is ranked from 10 (highest) to 1 (lowest).

### Quality High Dividend Payers

Companies Must Have Dividend Yields Above the Tech Sector's Yield that Meet Quality Metrics

Ticker	Company	Market Cap \$Bn	Quality Rank	NTM P/E	Dividend Yield
QCOM	QUALCOMM Incorporated	103.8	9.4	17.0x	2.8%
TXN	Texas Instruments Incorporated	124.3	9.2	29.2x	2.7%
PAYX	Paychex, Inc.	26.3	8.6	26.3x	3.4%
NLOK	NortonLifeLock Inc.	11.7	8.4	16.0x	2.5%
CSCO	Cisco Systems, Inc.	198.5	8.2	15.0x	3.1%
GRMN	Garmin Ltd.	19.1	7.4	25.5x	2.4%
TEL	TE Connectivity Ltd.	28.4	7.0	18.6x	2.2%
CSGS	CSG Systems International, Inc.	1.4	6.8	13.1x	2.2%
NATI	National Instruments Corporator	4.9	5.8	31.2x	2.7%
DOX	Amdocs Limited	7.9	5.8	12.8x	2.2%
<b>Sector Average</b>		<b>111.8</b>	<b>5.0</b>	<b>26.1x</b>	<b>1.0%</b>

Source: MarketDesk Research. **Quality** is ranked from 10 (highest) to 1 (lowest).

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