FINANCIAL REVIEW

The tech bubble is bursting - and no one can agree what comes next

The shares have fallen sharply from lofty pandemic highs, yet fund managers are divided on whether further pain or a rebound lies ahead.

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Two years ago, Maroun Younes, a portfolio manager for Fidelity in Sydney, launched a new fund hoping to capture the excitement sweeping global financial markets as technology shares soared, defying the global recession.

The portfolio would hunt "the stars of tomorrow", from the vast universe of small and mid-sized businesses around the world that might one day blossom into "household names like Apple and Amazon," Younes said at the time.

The Fidelity Global Future Leaders fund loaded up on technology companies and jumped more than 30 per cent in its first year, as investors dashed into fast-growing software and cloud computing businesses that surged through the early months of the pandemic.

This year, however, the fund has fallen sharply, ending each month lower than the last. The portfolio has shed nearly a fifth in value from the peak late last year as sharemarkets have responded violently to a turn in sentiment for the very technology companies that powered Younes' early gains.

The Nasdaq index has fallen by a quarter from its peak last year while Australian tech shares have dropped 40 per cent from their peak. **Allie Joseph**

"The industry is structured around short-term performance. It forces people to stay in there for as long as they possibly can, knowing that at some point things are going to change," he says about growth managers trying to navigate the volatility.

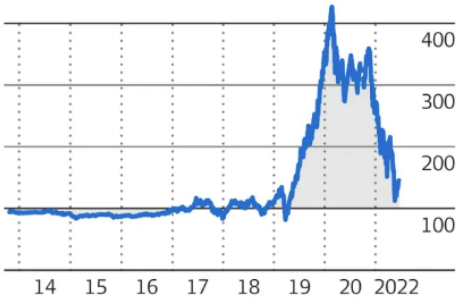
"It's like playing musical chairs," he adds. "There's one less chair each round and you know the music is going to stop, but up until it does, you have to keep walking around and around."

This year, the music has stopped with the grace of a stylus skidding off the vinyl. The tech-heavy Nasdaq index has fallen by a quarter since its peak in November, while the S&P/ASX 200 technology index has tumbled 40 per cent from a high in February last year as local giants like Afterpay, which now trades as Block, have crumbled.

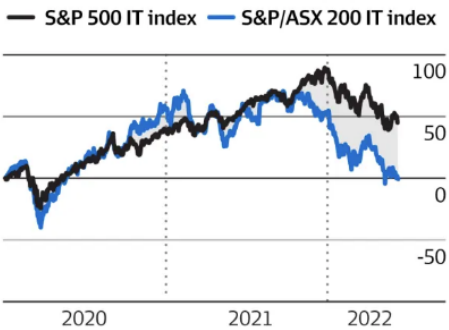
How far US tech stocks have fallen from peak to trough

Stock	Date	Peak ($US)	Date	Lowest ($US)	Difference (%)
Coinbase	9 Nov 2021	357.39	11 May 2022	53.73	-84.97
Zoom	23 Oct 2020	559	20 May 2022	87.74	-84.30
Roku	12 Jul 2021	473.65	9 Jun 2022	92.37	-80.50
Netflix	29 Oct 2021	690.31	6 May 2022	180.97	-73.78
Block	6 Aug 2021	275.1	9 Jun 2022	76.58	-72.16
Alibaba	23 Oct 2020	309.92	11 Mar 2022	86.71	-72.02
Meta Platforms	10 Sep 2021	378.69	9 Jun 2022	184	-51.41
Tesla	4 Nov 2021	1229.91	24 May 2022	628.16	-48.93
Salesforce	12 Nov 2021	306.65	20 May 2022	159.65	-47.94
Amazon.com	9 Jul 2021	185.97	20 May 2022	107.59	-42.15

Goldman Sachs non-profitable technology index (points)



Comparative performance (%)



SOURCE: GOOGLE FINANCE, BLOOMBERG

"There are tech companies like Afterpay where you can just look and think, wow, this is nuts," says Simon Mawhinney, chief investment officer of Allan Gray, a value fund manager.

Mawhinney, a veteran investor, railed against Afterpay's share price when it eclipsed $100 in 2020, months before it peaked, and questioned the market's sanity in driving the price higher.

Anton Tagliaferro, founder and investment director of Investors Mutual, one of Australia's best known value investors, echoed the sentiment. He marked the moment the buy now, pay later darling's share price hit three figures by querying whether the market was "correctly pricing in fundamentals".

The likes of Mawhinney and Tagliaferro were dismissed as out of touch for failing to join in the tech triumphalism. Their performance suffered as they put their faith in old-fashioned industrial stocks like Brambles, Amcor and Orica and out-of-favour oil companies like Woodside.

Now, the dramatic shift away from tech shares has validated their scepticism while the growth funds that previously outpaced them are struggling.

Many investors wrongly view tech shares as "some sort of holy grail", says Tagliaferro, rather than thinking of them as "just another sector of the market".

"Yes, there's been some spectacular winners, as there has been in mining stocks, but for every success, for every Facebook, there will be many that don't make it."

Simon Mawhinney, chief investment officer for Allan Gray, remains sceptical of tech shares despite the tumble. **Renee Nowytarger**

So, how did shares in the technology companies that came to represent a wave of disruption and innovation stumble so quickly and what happens from here?

If there can be a single factor that can claim responsibility it must be the moment the illusion of endless free money ended.

"As you approach the speed of light, the laws of Newtonian physics break down," says Chris Tynan, an investment analyst for DNR Capital, a Brisbane-based fund manager.

“As you approach zero nominal interest rates, the laws of valuation break down. That’s why you witnessed companies trading on 50 times sales and these cryptocurrencies appear and disappear. It just didn’t make sense.”

Now, inflation has changed the game. Central banks are responding aggressively to quickly rising consumer prices with higher interest rates, forcing investors to rethink the value of future profits across the tech complex.

“When the Fed said they would do anything to get inflation under control, that’s when things really started to happen,” says Younes.

Rising rates devastate tech shares because investors reduce the present value of future earnings, hitting hard the market value of profitless companies or so-called concept stocks.

Higher interest rates also increase the cost of capital, adding an extra burden for businesses relying on borrowed money to stay afloat.

“If you’re burning cash and any profits you have are five years-plus out, you’ve been severely hit,” explains Tynan.

“What is much more valuable is companies generating cash now, and that’s in the form of energy and resources stocks.”

Anton Tagliaferro, founder and investment director of Investors Mutual, said tech company valuations became detached from fundamentals. **Dominic Lorrimer**

Yet, there is more to the tech wreck than higher interest rates. The US mega-cap stocks like Amazon, Netflix, and Meta are highly profitable and therefore less sensitive to movement in interest rates. But they, too, have been belted.

“Most of the growth in their valuations [during 2020 and 2021] was actually earnings growth,” says Tynan, which he attributes to a “pull forward in digitisation” through the early stages of the pandemic.

“What’s happening for them now is there’s actually a slowdown in earnings. They’re less exposed to interest rates, but there’s a meaningful slowdown in earnings.”

In March, portfolio managers at T. Rowe Price, one of the world’s largest fund managers and one that has a long history of investing in growth companies, spoke with Amazon executives.

“They were pretty confident about the recovery of volumes and commerce,” says Sam Ruiz, a Sydney-based investment specialist for funds giant, before an abrupt shift in tone at a follow-up meeting two months later.

“In the space of six or seven weeks, they said to us everything changed. Now, all of a sudden, they overbuilt their logistics and warehousing footprint and they’ve got too many staff.”

A similar dynamic has altered the growth ambitions of technology companies, triggering a wave of lay-offs and hiring freezes at Netflix, Meta, Twitter and Amazon.

“It’s amazing how a 50 to 75 basis point hike by the Fed is already creating a sell-off in demand that is already impacting margins,” Ruiz says.

The combination of the souring environment and plunging valuations means these once high-flying tech stocks are tumbling, weighing on the broader market. But not everyone believes it’s time to abandon tech.

“If you’re a long-term investor, and you’re willing to wear the short-term volatility, then I think it’s a great time to invest,” says Thomas Rice, a portfolio manager for the Perpetual Global Innovation Share Fund.

Rice’s biggest position is in US online residential real estate company Opendoor Technologies, which has halved in value this year. He says the business has been unfairly caught up in the sell-off.

He also has an eye on enterprise software companies like Microsoft, ServiceNow, Salesforce, and MongoDB, which have become more attractive after declines this year.

Managers of the global innovation and disruption fund Holon Photon, which holds names like Coinbase and Tesla, are just as bullish on the large-cap tech stocks as they were two years ago.

“The opportunity now is in a lot of great technology stocks,” says Holon’s research director Tim Davies. “Now’s the chance to do the work to go ‘I want to buy’.”

The fund has added to a position in Meta and bought into Netflix after the shares fell sharply in April, in addition to loading up on Alibaba and Tencent, two Chinese tech giants that sank last year.

Cathie Wood, the queen of tech bulls who runs the ARK Innovation Fund, has also doubled down on tech despite a collapse in the value of her portfolio’s holdings this year.

Cathie Wood, founder of Ark Invest, remains bullish on tech shares. **Sam Mooy**

On Thursday, Wood told attendees at Morgan Stanley’s Sydney conference that “we’re at the threshold of the most explosive innovation age in the history of the world”, and that the mojo would eventually return to tech stocks like Zoom, Tesla and Roku, which are among her fund’s largest holdings.

For others, however, the scepticism pressuring technology shares will remain against the backdrop of tightening financial conditions and the threat of recession looming over the global economy.

“There is compelling value out there, but I don’t think it’s among the companies that capture the hearts and minds of everyday people,” says Simon Mawhinney of Allan Gray.

“Take BNPL, they haven’t made money in the best of times. How on earth are they going to make money in the worst of times?”

The Australian Financial Review

By Emma Rapaport