WHERE DOES TECHNOLOGY GO NEXT?

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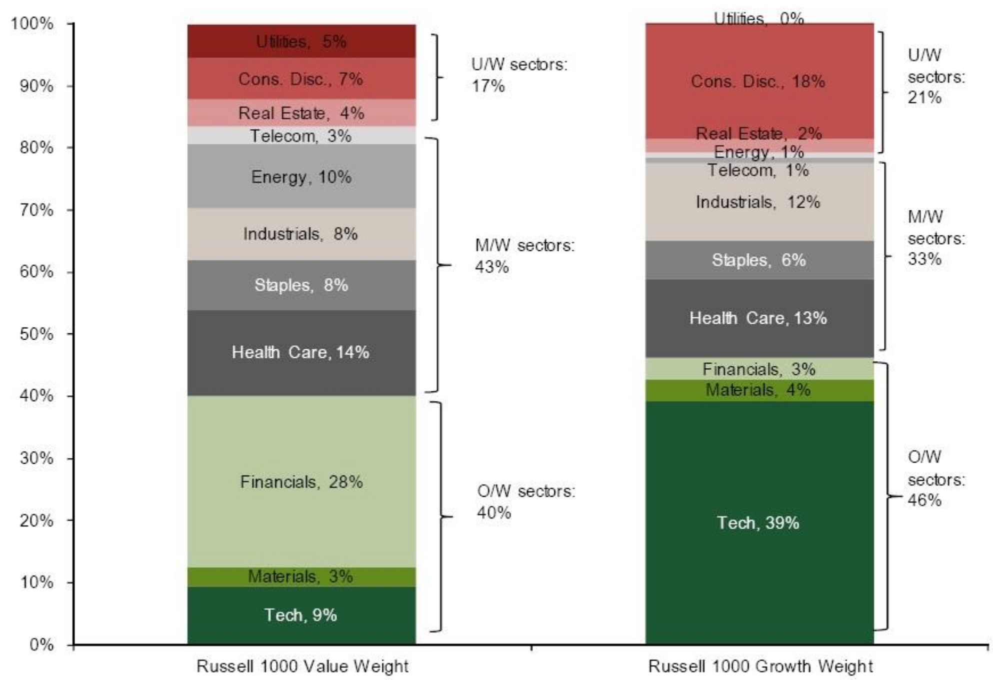
Should we worry about the predominance of technology in the benchmarks? The technology sector was 39% of the Russell 1000 Growth at the end of March 2018 versus only 9% of the Russell 1000 Value.

Growth = Tech; Value = Financials

Russell 1000 Value and Russell 1000 Growth sector weights vs. BofAML US Strategy views (All weights as of 3/13/18)

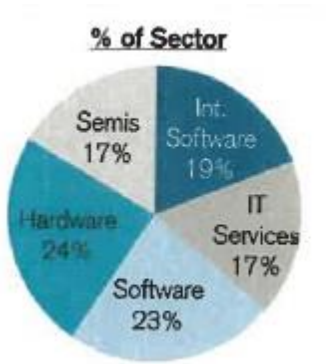


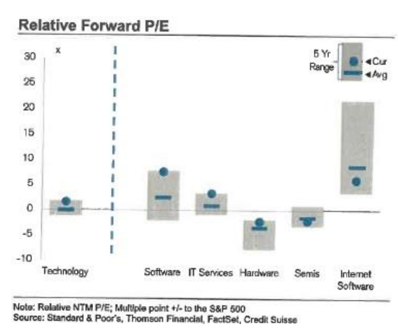
Source: BofAML US Equity & Quant Strategy, FTSE Russell

However, despite the strong performance of technology in general and the dominance of the FAANG themes in many growth investors' portfolios, we believe that there is ample support for continued growth and relative outperformance of technology, particularly if investors are willing to move down the market cap spectrum.

Perhaps instead of thinking about technology as a sector, we should shift our thinking to technology as the core building block for all industries. As technology permeates our world, whether the use of credit cards or epay apps for parking meters, electronic health records in hospitals, video doorbells and other smart home applications, parking and land control assistants in automobiles, flipped classrooms and online college courses, it becomes clear that technology is now a part of every industry that exists. In fact, we can cite a laundry list of new applications including smart cities, homes, and autos, mobile applications for commerce, banking, health, and the cloud continuing to take share from the enterprise (perhaps a form of the sharing economy). Therefore, by classifying companies based on their use of technology as a building block for delivering a consumer or industrial good, are the benchmarks over-stating the concentration of technology? We could argue that the current system of classification understates the importance of technology to global economic growth and human existence as companies such as Netflix and Amazon are classified in the consumer discretionary rather than the technology sector. We can envision a world where most of the S & P or Russell Indices become technology as its importance as a driver for most companies becomes clear. In recognition of this reality, S & P has recently recognized that unless they restructure some of their sector definitions, technology will only increase in size and weight which will make portfolio construction more difficult. They will be moving many of the media companies into telecom at the end of Q32018 which should help rebalance sector weights in the benchmark.

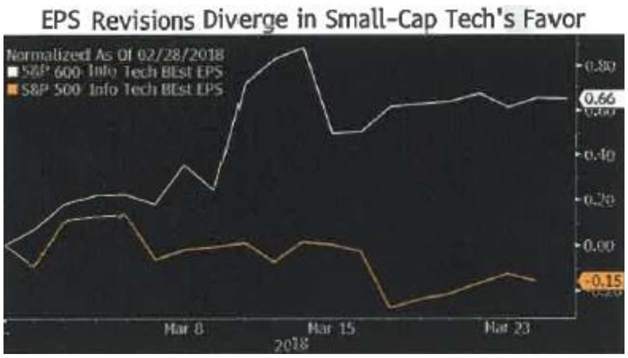
However, what about the argument that technology stocks are overvalued given their extraordinarily large weightings in the growth benchmarks? Perhaps the difference in technology weighting between the growth and value benchmarks is a reflection of the market share shifts that are occurring between companies that are harnessing cloud computing, social media, optical technology, etc. to deliver a better solution to their customers and those that are stuck in thinking that their business is delivering buggy whips to horse -drawn carriage drivers. In addition, although there are certainly individual stocks that are very highly valued, in general, technology is reasonably valued versus the rest of the market especially when the strong growth prospects and balance sheets of the sector are taken into account.

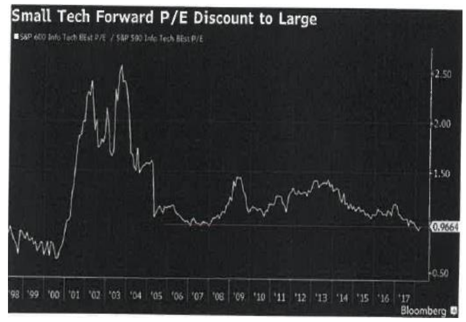




Source: Credit Suisse, April 2018

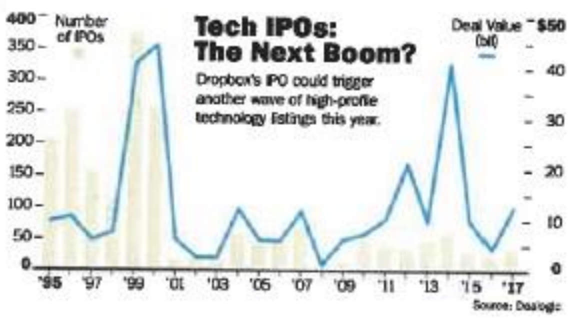
Although we believe that the opportunity set in technology is robust across all market cap segments, we are most excited about the opportunity that exists in the smallest cap segments of the market due to the combination of low exposure in the benchmarks, strong growth prospects, and lower valuations. As a result, earnings growth could drive small cap tech performance going forward on both an absolute and relative basis. The charts below show the divergence in growth expectations between the larger and smaller cap tech stocks as well as the meaningful discount between the two. In fact, this discount is the largest that it has been since 2007.





Source: Bloomberg, 2018

This discount also shows in the different weightings for the technology sector between the benchmarks. With a weighting of only 19% in the Russell Microcap Growth Index versus 25% in the Russell 2000 Growth Index and 39% in the Russell 1000 Growth Index, we believe that the prospects for future growth are least well recognized in the micro cap sector of the market. The lack of technology IPO's has also been a factor as the number of public technology companies continues to subside. We are seeing early signs that the logjam of technology IPO's may be starting to burst. Venture capitalists, from Fred Wilson, a partner at VC firm Union Square Ventures to Jason Green at Emergence Capital expect to see strong IPO years in 2018 and 2019. Tech guru Bill Gurley told CNBC that "it is cool to come public again". Although many of these IPO's will be unicorns, a large number will come public as small and micro cap stocks driving both supply and investor enthusiasm in the space. As we can see in the following chart, we are approaching 20 years of sub normal issuance of public equity based on the number of IPOs.



We recognize the short-term issues that have investors concerned about the health of the technology sector whether it be the maturation of the smart phone market, the risks of a global trade war, or concerns over the semiconductor cycle. However, we expect that the current earnings season should provide ample opportunity to identify small and micro cap technology companies we believe that are well-positioned to capitalize on these exciting growth opportunities.

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