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## Technology Investing: Volatility, Valuations and Opportunity

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Despite increased volatility due to the Russia-Ukraine war and rising interest rates, Franklin Equity Group's Jonathan Curtis sees compelling opportunities within high-quality technology companies in an increasingly digital world.

Markets have been exceptionally volatile since mid-November, as investors have digested the impacts of rising inflation, pending US Federal Reserve actions, the potential end of the COVID-19 crisis, and the tragic situation in Ukraine. Rising interest rates have reduced what investors are willing to pay for growth and "cash-in-the-future" businesses, and may increase the risk of recession amid the inflationary backdrop of rapidly climbing fuel and food prices.

Even though rising rates reduce what investors are willing to pay for higher-growth companies, they are also usually indicative of a strong or improving economic backdrop, which tends to be good for more economically sensitive small- and mid-capitalisation (mid-cap) businesses. Economic conditions appear robust in the United States and Europe, but inflation is robust, too. As central banks increase rates to rein in inflation, there is risk that economic activity loses momentum and serves as a moderate headwind to the near-term growth prospects of less-diversified small- and mid-cap companies. Investors have anticipated this, which has driven equity valuations down meaningfully.

In our strategy, we tend to emphasize higher-growth small and mid-cap companies, which are earlier in their journey towards profitability. These factors have been out of favour for the past few months, and, unfortunately, the indiscriminate selloff has not taken solid individual company fundamentals into account, in our view.

We believe that well-capitalised, cash-consuming companies with strong unit economics (revenues and costs in relation to an individual unit) and leading positions in large and secular growth markets can be excellent businesses under any kind of interest-rate scenario. In volatile periods like the one we find ourselves in today, companies with these attributes can leverage their leading position and easier access to capital to consolidate market share and pull ahead of their capital-constrained peers. We are long-term, growth-oriented investors with quality at the centre of our process. As we have seen superior businesses with attractive long-term prospects—some with cash-consuming profiles—sell off, we have been taking advantage of what we consider improved valuations to add to our positions.

### Impact of Russia-Ukraine War on Europe and China

We pay close attention to where companies generate their revenues to understand their short- and long-term prospects. Given Russia's actions in Ukraine, we believe the risk of recession is on the rise in Europe, which makes us more cautious towards companies with higher European exposure. China's increasingly stringent and opaque regulatory regime has also kept us from investing in the country. Conversely, we have greater confidence in companies with higher leverage to the US economy. We have also been focused on higher-growth emerging markets throughout Asia.

We anticipate a modest near-term impact to the production of semiconductors and technology hardware that requires nickel and titanium, along with semiconductor-grade gases (neon, xenon, argon and krypton), which are sourced partly from Ukraine. Importantly, our research indicates that there are significant buffer inventories of these critical materials around the world, which we believe can last for at least six to 12 months. In addition, previous efforts were made in the wake of Russia's 2014 annexation of Crimea to find new sources of neon (used in silicon chip lithography) outside of Ukraine. That said, as semiconductors are essential enablers of our digital lives, a prolonged supply disruption would likely present a revenue and/or cost headwind for the broader "Digital Transformation" opportunity. We believe the challenges would be most acute the closer a vendor is to the direct inclusion of semiconductors in its products.

## Growth Sector Outlook

As long-term investors, we don't strive to make short-term trading decisions at the sector or style level. The case for investing in technology companies is compelling, in our view, regardless of where we find ourselves in the economic cycle. Enterprises and consumers invest in technology to drive better productivity. We think enterprises are most willing to accelerate their investment in technology when they see their own prospects improving. The inverse is also true. In addition, if inflation headwinds persist on the labour side of the market, we believe enterprises will look to technology and business process improvements to better manage their costs. Such investments would be a tailwind for our "Digital Transformation" thesis, which could help to offset recessionary headwinds.

Longer term, we see significant opportunities across a range of themes, which range from artificial intelligence (AI), machine learning and analytics to new commerce and digital customer engagement, to cyber security, electrification, autonomous technology (enriching automated systems with sensors, AI and analytical capabilities), and more. While all these opportunities are compelling, we believe the secure cloud and SaaS (software as a service) theme represents the largest opportunity as it underlies all other digitisation trends. None of the other themes are possible without the cloud. We are also excited about digital media transformation and the rise of the metaverse (a fully realised digital world). We believe the metaverse opportunity may represent the ultimate "Digital Transformation" application.

## What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Investments in fast-growing industries like the technology sector (which historically has been volatile) could result in increased price fluctuation, especially over the short term, due to the rapid pace of product change and development and changes in government regulation of companies emphasising scientific or technological advancement or regulatory approval for new drugs and medical instruments.

Past performance does not guarantee future results.

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