Janus Henderson INVESTORS

From Old to New

As the global economy increasingly turns digital, our portfolio managers discuss how investors might benefit from the transition.

Global Technology Fund

China in the Digital Economy

Portfolio Manager Denny Fish discusses China's efforts to become a global leader in technology and the related opportunities and risks for investors.

Denny Fish
Portfolio Manager

Q China is emerging as a vanguard of the digital economy. Mobile payments, for one, have exploded there, while usage in other countries has been slower. Why?

Mr. Fish: There are a few things at work when it comes to the rapid adoption of mobile payments in China. For one, the majority of the population does not have a credit card, and so the country does not have legacy infrastructure associated with payments, such as in the U.S. Second, in China, the first entrée to the Internet was the mobile device, not the PC. So you have a society that is increasingly connected to the Internet but primarily through a smartphone. And as smartphones have proliferated, so too have the two major payment platforms – Alibaba Group's Alipay and Tencent Holdings' WeChat Pay – which are embedded on just about every device. Consequently, Chinese consumers are very comfortable with the platforms and with operating in a mobile-first world.

Now compare China's experience to what's happened in the U.S. and Europe. Plenty of digital payment options are available to consumers in both the U.S. and Europe, and smartphones are ubiquitous. But the reality is that even though digital payments are generally easy to use, there's also little friction to pulling out a credit card, processing the payment and going about your day. As a result, consumers are not incentivized to change their habits.

Q China says it wants to be the world leader in artificial intelligence (AI) by 2030. Is that possible?

Mr. Fish: I think China certainly has some advantages when it comes to AI. For one, it has become a strategic imperative of the government, backed by a multibillion-dollar national investment and significant venture capital funding. In addition, the country has 1.4 billion people from which data can be collected. The key to AI is not algorithms or hardware because algorithms are open source and you can buy hardware. Instead, the toughest part is getting the right data to apply AI against. To that end, the Chinese are generating much more data than the U.S., and, importantly, the country's idea of data privacy and security is far different. The average Chinese consumer accepts that he or she does not have data privacy rights. In Europe and the U.S., the rhetoric and potential for regulation around data privacy are only getting louder. So at a time when the amount and type of data are important to developing or leveraging AI, you have the Western world pulling back, while China is opening the floodgates.

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Q How are some firms benefiting from the digital-first mentality in China?

Mr. Fish: Some companies are providing the infrastructure for these new technologies. For example, Nvidia, a U.S. chip manufacturer, makes the GPUs (graphics processing units) needed for facial recognition, which has just exploded in China. Or a company such as Cognex develops machine vision systems used to automate manufacturing.

As for mobile payments, Alibaba and Tencent are the largest digital payment platforms in China, and they are expanding their footprint to other countries. Plus, mobile payments are just the beginning. These companies are taking the relationship they have with customers and merchants and offering additional services. Ant Financial, an affiliate of Alibaba, operates Alipay, as well as the largest money market fund in the world, with more than 400 million users. Ant also has a credit scoring arm and a lending business. The company now has an estimated market value of $150 billion – larger than Goldman Sachs – and was only officially established in 2014. The growth has been breathtaking.

Q Are there risks to this rapid growth?

Mr. Fish: We've certainly seen regulatory risks. Last year, Beijing stopped approving new video game licenses, citing concerns about gaming addiction and violence in video games. The majority of Tencent's gross profit dollars are derived from distributing video games. So, effectively overnight, Tencent's ability to monetize games was impaired.

The ongoing trade battle between the U.S. and China is another risk, with demand destruction or the additional expenses associated with tariffs starting to impact company earnings, including in the semiconductor space. Long term, we believe the secular tailwinds associated with AI and other mega-tech trends, such as the Internet of Things, will drive growth for semiconductor companies. But in the near term, the trade battle can be a headwind for the stocks.

Q What about legacy tech companies: Can these firms still compete as new leaders in both developed and emerging markets grow?

Mr. Fish: Microsoft is a great example of a legacy tech giant that has made the transition. This is a company that for years operated in the client-server PC world and shipped software on a CD or had customers download software onto a computer. Fast-forward to today and Microsoft has built a full-fledged cloud computing platform. More importantly, the firm has re-architected all of its products for the cloud, the primary reason Microsoft is growing at a fast pace.

In this environment, we think it is critical for companies to reinvest in their business and innovate quickly. China is committed to building its technological prowess, and its investments in AI and access to data give it an advantage. At the same time, you cannot discount the innovation engine in the U.S. and its ability to crank. I see it firsthand in the [San Francisco] Bay Area all the time and it's just so unique. In our opinion, tech companies that adhere to old Wall Street ways and optimize for profits at the expense of innovation – at a time when disruption has never been higher – are likely pursuing a strategy that will be detrimental to their long-term success.

Forty Fund

Growth in the New Economy

Companies with powerful platforms, direct relationships with customers and a strong raison d'être may offer investors some of the best opportunities for growth, says Portfolio Manager Doug Rao.

Doug Rao
Portfolio Manager

> "To continue delivering organic growth, we think companies increasingly need to have a direct relationship with their customer and a powerful feedback loop."

Q Revenues of some "new economy" companies have grown significantly faster than the S&P 500® Index in recent years. What explains the gap?

Mr. Rao: It speaks to the power of platforms, which are capturing so much market share. Once these systems become intuitive – whether that's figuring out how to stream content on Netflix, ordering from Amazon or, if you are a surgeon, operating with a surgical robot – people tend to rely on these operating systems.

Q Are there any "old economy" companies that, like these tech platforms, can capture significant market share today?

Mr. Rao: Disney is one example. The blue-chip company has been included in the Dow Jones Industrial Average since 1991 and has been publicly traded since 1940, with business lines that include film production, media networks and theme parks. Outside of these more traditional businesses, Disney has recently emerged as a major player in online video platforms, rapidly gaining subscribers in a market that includes competitors like Netflix and Amazon's Prime Video. Disney has been able to leverage valuable intellectual property from its legacy franchises to Disney+, its direct-to-consumer app and streaming service, as well as the ESPN+ and Hulu streaming services. This is a great example of a company embracing disruption and leveraging technology to enhance its business model and adapt to a changing environment.

Q Many large investable companies came of age before the digital economy. What are some ways that these firms can remain relevant?

Mr. Rao: To continue delivering organic growth, we think companies increasingly need to have a direct relationship with their customer and a powerful feedback loop. Using that feedback, companies can create products that continue to be relevant to their customers and, potentially, generate new sources of revenue growth. Firms also deepen their relationship with customers, which we think hardens the moat, or competitive advantage, around the business. It helps, too, to have a powerful raison d'être. A company like Home Depot – one of the few major home supply stores in the U.S. with products that don't always translate well online – has that. Many general merchandisers do not.

Q How are some U.S. companies taking advantage of the digital growth that is occurring globally?

Mr. Rao: Mastercard is a good example of a company that is benefiting from the explosion of digital payments worldwide. The firm's payments network has far-reaching acceptance globally, which we believe creates a strong network effect. At the same time, the majority of Mastercard's revenues are generated outside the U.S., where many markets have a lower penetration of card and electronic payments and are experiencing significantly faster electronic purchase volume growth. Furthermore, the company is increasingly processing business-to-business payments, bill pay and cross-border transactions and expanding its digital services.

Balanced Fund

The Digital Transition

Portfolio Manager Jeremiah Buckley explains how investors can potentially benefit as companies adapt to the new digital economy.

Jeremiah Buckley, CFA
Portfolio Manager

> "We believe businesses have to go where the consumer is buying products or being influenced by media."

Q Globally, more and more consumption is being done digitally. How have companies adapted to this digital-first world?

Mr. Buckley: Some global brands are investing in new distribution channels. McDonald's, for one, is rolling out digital applications like mobile order and pay, which allows customers to place and pay for an order via the McDonald's app. The franchise also is installing in-store kiosks, giving consumers a self-checkout type of experience. We think these and other investments are helping McDonald's stay relevant both in the U.S. and in other countries, including emerging markets. Even with some of the headwinds we've seen in emerging markets, McDonald's continues to do well in countries like China. We believe businesses have to go where the consumer is buying products or being influenced by media, and McDonald's is doing just that.

Outfront Media is another example. Historically, the company's business model centered on placing advertising on physical billboards. Now, Outfront is transitioning to digital billboards and screens on transportation systems. This turns out to be a higher growth model: Instead of physically changing ads at locations, Outfront just uploads ads digitally, creating more flexibility and quicker speed to market. We're still early in the transition, but over time, as Outfront rolls out more and more digital boards, we expect the company to generate higher revenue per location and improve profits.

Q These transitions seem to require significant investments in technology. What does that do to the bottom line?

Mr. Buckley: It helps if a company has scale. Historically, banking revolved around the branch and personal relationships. But as a new generation of consumers wants to do more online and through apps, rather than visit a physical location, banks have had to invest in digital capabilities. Big banks, such as Bank of America, have a large number of depositors over which they can spread that cost. Smaller banks do not, making the investment much more expensive. Meanwhile, as Bank of America builds its digital platform, the incremental cost of acquiring new customers is minimal. You no longer have to open new branches to grow your footprint. Bank of America's market expands, making it all the more difficult for small banks to compete, in our opinion.

Q How far along are we in these types of transitions?

Mr. Buckley: For old economy companies, we think we are in the early stages of the transition. It is one reason why we remain optimistic about the equity market. We feel a lot of these transitions, which are good for company productivity, are early on in their adoption.

Technology companies are often leading the transition. How do you participate in that innovation without taking on too much risk?

Mr. Buckley: A big part of our investment process is to look for firms with proven business models and positive free cash flow. We believe the range of outcomes for these types of companies is narrower, which can help lead to more consistent returns over time. As a result, we don't own some of the tech sector's high-flying stocks because many of these companies are borrowing to fund their growth. Instead, we prefer companies that are generating a lot of free cash flow and don't have to invest excessive amounts of capital back into the business to fund their growth.

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Past performance is no guarantee of future results. Investing involves market risk. Investment return and fund share value will fluctuate and it is possible to lose money by investing.

As of 3/31/20, the top 10 portfolio holdings of the Global Technology Fund are: Microsoft Corp (8.26%), Amazon.com Inc (5.36%), Apple Inc (5.05%), Adobe Systems Inc (4.46%), Salesforce.com Inc (3.87%), ASML Holding Nv (3.86%), Mastercard Inc (3.83%), Alibaba Group Holding Ltd (3.70%), Texas Instruments Inc (3.56%) and Taiwan Semiconductor Manufacturing Inc (2.95%).

As of 03/31/20, the top 5 portfolio holdings of the Forty Fund are: Microsoft Corp (8.07%), Amazon.com Inc (7.43%), Apple Inc (5.88%), Mastercard Inc (5.23%) and Alphabet Inc Cl-C (4.50%).

As of 3/31/20, the top 10 portfolio holdings of the Balanced Fund are: Microsoft Corp (8.28%), Mastercard Inc (5.32%), Apple Inc (4.25%), Alphabet Inc Cl-C (3.63%), UnitedHealth Group Inc (3.51%), Adobe Systems Inc (3.10%), Home Depot Inc (3.05%), Amazon.com Inc (3.00%), Merck & Co Inc (2.93%) and McDonalds Corp (2.89%).

There are no assurances that any portfolio currently holds these securities or other securities mentioned.

Foreign securities are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility, lower liquidity and differing financial and information reporting standards, all of which are magnified in emerging markets.

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Investments focused on a single sector, country or region are subject to increased volatility because such investments may react similarly to market developments and a significant portion of assets may be invested in a small number of issuers.

Technology industries can be significantly affected by obsolescence of existing technology, short product cycles, falling prices and profits, competition from new market entrants, and general economic conditions. A concentrated investment in a single industry could be more volatile than the performance of less concentrated investments and the market as a whole.

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