

Fidelity Connects

HyunHo Sohn, Portfolio Manager of Fidelity Technology Innovators Fund

Pamela Ritchie, Host

Voiceover: Hello and welcome to Fidelity Connects – a Fidelity Investments Canada podcast – connecting you to the world of investing and helping you stay ahead.

Joining us today to discuss how he sees the technology sector panning out in 2023 is HyunHo Sohn, Portfolio Manager of Fidelity Technology Innovators Fund. In December 2022, HyunHo was named Mutual Fund Manager of the Year by Investment Executive magazine.

It was a turbulent year for the tech sector in 2022. Soaring inflation, higher interest rates, and fears of a recession daunted consumers and investors, leading to mass layoffs within large-cap tech companies, and a market downturn that saw the Nasdaq 100 finish 32% lower on the year. So, should investors be more optimistic about a tech bounce back in 2023, and what are some of the macro stories that could help or hinder tech this year?

HyunHo answers these questions and more today with host Pamela Ritchie. HyunHo also comments on tech valuations, noting valuations are attractive right now, and his decisions are driven by focusing on company fundamentals with a long-term view. Also, how much are these valuations and fundamentals being controlled by macro variables.

A few other topics touched on today include mergers and acquisitions, cybersecurity, and e-commerce trends – specifically what trends accelerated during covid and are decelerating now, or what trends are here to stay. Stay tuned.

Today's podcast was recorded on January 12, 2023.

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Pamela Ritchie: Hello and welcome to Fidelity Connects. I'm Pamela Ritchie. Nice to see you again, HyunHo. How are you? Happy New Year.

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HyunHo Sohn: Happy New Year to you. Nice to see you. Thank you.

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Pamela Ritchie: How much of the tech sector story can be pinned on the pull forward in terms of valuations of what we did during COVID? Is that 50% of the story? Is that 100% of the story?

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HyunHo Sohn: That's really a tough question to start. It's quite confusing to many investors because tech innovation is a long-term story. There's a lot of macro uncertainty happening right now. Things are difficult to get a handle on. But then we experienced a period of COVID, which put a lot of demand for technology consumption from consumer perspective, and also corporate perspective. A lot of IT investment went into tech sector, which we are seeing some digestion of those investments happened over the last two years during the COVID. But the question is whether this is end of the investment cycle or there's some structural angle to it. I think, overall tech, there are many areas of structural story, but I have to admit that there's some area when we need some digestion of the investment *[that]* went into tech sector during the COVID.

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Pamela Ritchie: There are many pieces of the long-term story but, as you mentioned there, one of them is just how much we realized if we had not brought forward our technology skills, personal, corporations, that it had to be done. Where has it not really been done?

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HyunHo Sohn: A lot of tech investment has been done, but I would say, in general, more digital-oriented sector like tech, media and those areas, IT investment has gone very quickly and accelerated, whereas more traditional segments like manufacturing, industrial and resources... those areas have continued to invest in tech, but there are a lot more room for tech investment to go. I mean, thinking about ... particularly given emphasis on environmental energy consumption, efficiency and waste reduction; all these things, those sectors need help from technology investment. Basically, manufacturing facilities and factories need to be more connected digitally and they tended to be stored and analyzed so that people can see whether those factories and facilities are running efficiently and there more room for improvement, etc. I think all those things... investment in tech will be needed.

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Pamela Ritchie: When you think about China's reopening right now for every sector, for most people in business, the question mark is to what extent the reopening will have a positive impact to the overall business story. We'll get your thoughts on that. During COVID, we saw President Xi talk a lot about tech strategy. For instance, they, as a government policy, moved away from social media; they called it spiritual opium. We should be doing tech in places like health care, different industries. I'm curious, as you watch China reopen where do you think there are some government directed opportunities, ultimately, for the tech sector?

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HyunHo Sohn: There's two angles on China reopening. You're thinking about what happened in China during COVID; there's a lot of supply chain bottleneck because of workers that need to be isolated, so there are a lot of supply chain disruption happen because of the COVID in China. Chinese people couldn't travel outside of China, so there's demand weakness happen from there. If you think from that angle, reopening China, what does that mean? Supply chain bottlenecks will be eased, so, for example, iPhone production in China were disrupted because of COVID, but that kind of thing will be normalized. So, that will be good news for overall supply chain issues. Chinese people will travel overseas and that's going to be massive demand for global travel industry and etc., so that's going to be also impacted from tech perspective.

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Pamela Ritchie: So interesting. Did we see as much of a pull forward for Chinese tech stocks as we did in other parts of the world, for instance?

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HyunHo Sohn: China stock, during COVID, it was quite depressed, overall depressed. Economic activity and also the government regulatory pressure on overall the big tech platform in China, so that led to quite depressed Chinese tech stock. Now, given the reopening of China, actually, Chinese tech stocks – not just tech stocks, overall China’s stocks– are starting to rebound very rapidly. We are seeing a lot of Chinese tech stocks doing very strongly last month or so.

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Pamela Ritchie: Just move back to the global market, almost the cap size story. Some of the big heavyweight tech players, the large companies, obviously, have sold off by incredible amounts, sort of eye-watering amounts. What do you think of these valuations right now for some of the big players?

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HyunHo Sohn: Valuation of big tech... really to look at the company by company, but overall, I think valuation is quite attractive. People talk about valuation overall; I think company fundamentals. First, I think the large companies like Microsoft and Amazon joining the cloud computing space or Apple, Netflix and those companies... if you step back and think about the next three-five years, what would be the competitive advantage of those companies? Will those companies become stronger than today? My answer would be yes to most of the large companies. Those companies are generating a lot of cash flow and balance sheet is quite strong. As you mentioned earlier, valuation has derated quite substantially over the last year. So, from that perspective, I think we can see a lot of attractive investment opportunity there.

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Pamela Ritchie: What is the time horizon from your perspective, perhaps, on those companies, but maybe on others more broadly across technology?

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HyunHo Sohn: Timing is always very difficult. Fundamentally, macro is impacting on the fundamentals. Things are beyond the companies’ control; it’s difficult, and also market multiple, the interest [*indecipherable*], etc., that is impacting on stock price. It’s a difficult one. My approach is basically look longer term, step back because ... 2023, this year, we’re going to see slowdown, weakness. We’re going to see earnings downgrade and etc. If I think about it, whether the stocks will react negatively to those slowdowns and earnings downgrade, I don’t know; I think maybe not because rarely valuation has discount a lot of slowdown. People already have seen the negative headline and people expect things will slow down.

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I think this year, good approach would be stepping back and thinking about longer term, whether companies and subsectors and industry can maintain competitive advantage, whether tech adoption will be higher in three-year view. That’s the more important answer to think about. From that perspective, I would say there’s a lot of area for tech adoption to continue to go up; companies’ business model remain quite strong. A lot of tech business have cash generative business and strong balance sheet, so I see a lot of good attractive angle from longer-term perspective.

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Pamela Ritchie: Do you see that attractive longer-term perspective around the world in countries that, perhaps, are either emerging markets or just these other countries... is it a broader global view right now than, say, it was a year ago?

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HyunHo Sohn: I wouldn't say broader version here. My approach is that looking for attractive business globally, so I like companies that have very strong position in the global market. I find those companies across the globe. Obviously, the U.S. is in the driver's seat in the innovation. There are a lot of good companies in the U.S. But if you look at Japan, for example, I think Japanese companies will play quite important role in the automation and robotics. If we think about more factory automation ... and, also people talk about reshoring, right? A lot of manufacturing footprint focused on China in a competition to diversify manufacturing footprint outside of China to Southeast Asia and U.S. reshoring, and all those things actually need more automation and robotics. Japanese factory automation companies have a strong play there. European tech side, there are very strong companies, very high global market share in telecommunication equipment, fintech, the payment space, and software as well. I think the long-term winner, I continue to look for in the market globally.

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Pamela Ritchie: Do you think cloud investment -which is kind of what we talked about off and on for a couple of years when speaking with you- do you see that slowing a little bit or where do you see that particular area of tech expansion or growth? How does that stand to sell in 2023?

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HyunHo Sohn: Overall, cloud spending is slowing down, definitely. But I see that slowdown as more cyclical rather than structural. If you think about cloud penetration adoption, overall, we are still second or third inning. Obviously, cloud adoption accelerated during the COVID across world board, particularly more digital native start-up companies funded by easy money and venture capital. Then they start the business and ramp up quite quickly. Cloud infrastructure helped those new companies to start competing very quickly. So, that sort of acceleration and we are seeing some significant brake on those investments. Obviously, the investment built up quite quickly and then we need some period of digestion. So, that is impacting on cloud slowdown. Microsoft or AWS in the recent quarter earnings, they admit that things are slowing down. But if they step back and think about more... larger enterprise and big segments like financial institutions and health care and government; those big area, we're still very innings in terms of migrating enterprise workload, traditional workload to the cloud migration. I think there will be significant headroom over the next three to five years.

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Pamela Ritchie: Do you think we'll see more M&A over the course of the next, I don't know, 12 to 18 months as actually some of the big tech players perhaps scoop up some of the more struggling longer-duration companies?

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HyunHo Sohn: I think that's an interesting question and I think M&A will be an interesting theme for this year and we're going to see more activities. Actually, last year as well; we saw quite a lot of M&A activity more in the smaller software companies and key players were mainly on the private equity side because the high growth, high multiple, unprofitable companies got taken up by private equity over the last year. We really saw some transaction this year as well. The high multiple software companies got derated massively over the course of last year and become more attractive to the

private equity companies. That will continue, in my view, this year. I think this year we are going to see more strategic M&A. So, large tech companies look for more the growthy companies so that... these large companies have very strong balance sheet and continue to look for the growth angle and strategic M&A will be important part of the growth strategy for those large companies. So, yes, I see more M&A happening this year.

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Pamela Ritchie: There's so many different headlines about chips, about semis; they all tend to be quite political, a lot of the commentary and so on. There's been big bills passed to make sure that they can be domestically produced and so on in various countries. From an investment standpoint, should we look at any of these headlines? How do you look at that space?

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HyunHo Sohn: You mean semiconductor side chips. I think U.S. making a big headline, but not just U.S., Europe and Japan as well, China also. The government realized that semiconductor is very important part of economy and the key building block of innovation and even national security. I think government incentivization of the companies build semiconductor factories in their area countries, I think that's going to be beneficial for overall investment in tech. So, semiconductor equipment will be continued to be interesting area within tech.

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Pamela Ritchie: There's some linkages, again, in sort of headlines. I'm just curious from your perspective if they are real linkages. You'll hear about companies looking at going into space -you can figure out who they all are talking about-, making sure they have the rare earths to keep up their production lines and incorporating it into the companies themselves, the tech companies. Is that for real? Are rare earths something that tech companies are going to make sure that they have access to directly? What do you make of all of that?

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HyunHo Sohn: It's more of a resources and material area, so I'm not particularly looking into those areas.

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Pamela Ritchie: It's not a main thing. It's something we hear a lot about. When you see, ultimately, areas like e-commerce; we have probably become so dependent on areas of that that they'll stick. What are some of the other areas that we'll either stick with because of the pandemic or maybe we're sick of them? I don't know.

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HyunHo Sohn: Acceleration happened during COVID and now decelerating. People think that there's a change it or not, but I think a lot of things are quite sticky. A good example would be... you mentioned e-commerce, but on-demand media consumption, food delivery. There's a lot of demand for food delivery because people are stuck at home. Now they're still slowing down, but I think that habit, it becomes sticky. People see the food delivery, the convenience and utility is people value that. We are seeing some slowdown from the high base, high level, but I think those kinds of things will be structural habit change.

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Pamela Ritchie: Thoughts on fintech that might have been hurt last year, for instance; do their valuations seem more reasonable now?

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HyunHo Sohn: Fintech... I invest in credit, the card network and merchant acquirers. Those businesses are quite attractive business. Cash to digital payment has accelerated and there continues to [be] more room to grow, particularly in Europe and elsewhere. U.S. is a bit well penetrated. I think the fintech payment area, I think it's an attractive area there. But fintech is quite broad terminology. If I'm asked about BNPL –buy now, pay later– those kinds of business model; I might use that. It's structurally very challenged. Some areas within fintech, where easy money helped a lot during the COVID, I think there's a structural challenge there. But overall, fintech, the payment and digital space, I think there is more innovation and growth angle there.

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Pamela Ritchie: On the cyber security front, again, maybe from a valuation perspective, but is there a different type of demand? I think we're more aware also of concerns around cybersecurity than we ever were.

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HyunHo Sohn: Investment in cybersecurity will continue. Cybersecurity budget is one area that the CIO, CSO, don't cut easily. From an investment and budget perspective I think cybersecurity will remain a strong area. But one question is... it's quite important to be quite selective and look at the business by business because cybersecurity budget-wise is quite strong, but a cybersecurity product itself... need to be a lot of changes happening. For a cybersecurity company to remain competitive you need to continue to invest in R&D. This product is inherently quite complex, so you need to spend a lot of money to the marketing, education of the customer, etc. That's why we do not see a lot of cybersecurity company to generate profitability. I think overall industry wise, attractive industry but from company to company, I would say I need to be more selective.

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Pamela Ritchie: What about a cybersecurity firm, companies that have sort of an enterprise approach to things, or less just specifically cybersecurity?

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HyunHo Sohn: Within cybersecurity I'm positive about endpoint cybersecurity, so proliferation of mobile devices and tablet and etc., and endpoint security is a very essential part of overall cybersecurity in a big market. There are generation changes within the endpoint cybersecurity market, so there are companies that are well positioned to address this big market and those companies generate decent profit and cash flow.

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Pamela Ritchie: How did you manage all the volatility last year?

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HyunHo Sohn: Discipline in terms of looking at the valuation of a company, the fundamental. I try to avoid very expensive stock and good story, the market chased the momentum; those kind of stocks I try to avoid. I focus more on companies that actually have a very good business model, strong long-term competitive advantage, delivering good long-term earnings and cash flow, trading on regional multiple and market doesn't favour at that point, but reasonable valuation and attractive long-term potential; those kind of stocks I invest in. I think that helped me perform relatively better than other tech funds.

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Pamela Ritchie: And it might also be the reason that you won Mutual Fund Manager of the Year by Investment Executive Magazine. HyunHo, it's great to see you again. Thank you very much for joining us and Happy New Year to you.

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HyunHo Sohn: Thank you. Happy New Year.

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Thanks again, see you next time.

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