# ‘Safety trades’ in the technology sector

March 2022

**Research Signals**

The technology sector was the clear winner during the speculative mania coming off the March 2020 market bottom, as stock market cowboys bid up meme stocks and the most expensive growth shares. In a turn of events at the start of 2022, though, signs of higher inflation and the prospects for several rounds of Federal Reserve interest rate hikes and quantitative tightening weighed on long duration assets, particularly the technology sector, dragging down the broader market with it. However, we highlight some perhaps overlooked safe havens within this segment of the market during the tech selloff.

- While investors were mostly agnostic to profitability during the tech run up in 2021, profitable firms weathered the ensuing downturn more effectively than the broader sector and to a greater extent relative to nonprofitable firms
- High quality technology firms scoring in the top 20% of Return on Invested Capital universe rankings have outperformed the sector by 14.6 percent points over the past year
- Value investing’s return to favor in the second half of 2021 eventually carried over to the technology sector, as shares with attractive TTM Free Cash Flow-to-Enterprise Value outpaced the sector in the openings months of 2022

## Macro view of recent market trends

Before the Russia-Ukraine conflict erupted, markets were already experiencing heightened volatility, with February marking a second month of widespread losses for markets in the US and around the globe. Considering the SPDR S&P 500 (SPY) and Invesco QQQ Trust (QQQ) ETFs (sourced from the IHS Markit ETF Analytics database with dividends and fees included), we see that the tech laden QQQ suffered greater losses than SPY through mid-March 2022 (Figure 1), as concerns over higher inflation and ensuing central bank interest rate hikes and monetary tightening were exacerbated by the Russian invasion of Ukraine.

Drilling down to the sector level, we next compare price performance between the Technology (XLK) and Utilities (XLU) Select Sector SPDR Funds, representing the two extremes of defensive value and high growth sectors, overlaid with the trend in 10 year treasury yields (Figure 2).

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Figure 1

**ETF NAV (with dividends and fees) performance**


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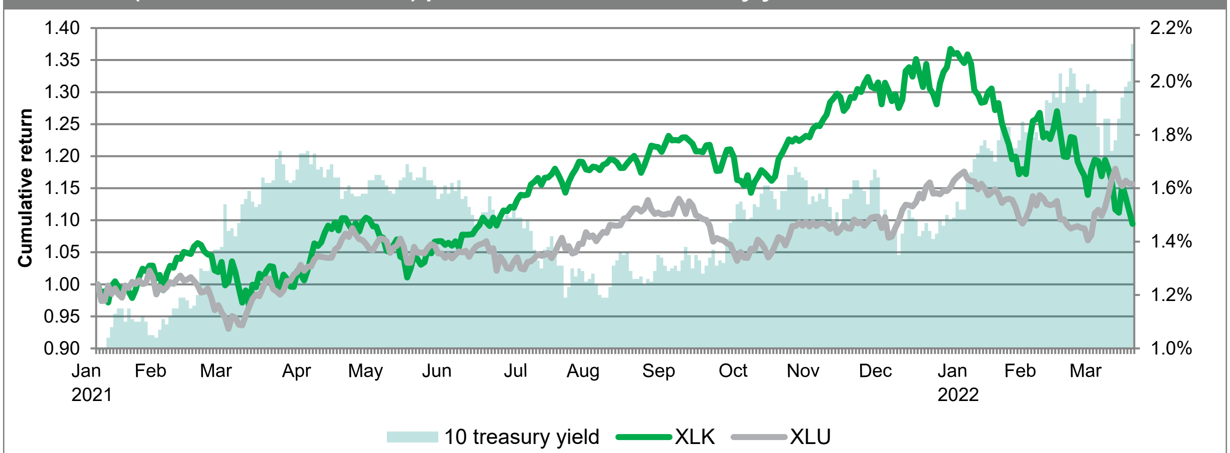
In 2021, yields fluctuated as vying forces from macroeconomic activity, US Federal Reserve policy and inflation expectations impacted the outlook on interest rates and, in turn, XLK and XLU showed little influence from the movement in interest rates. However, in 2022 investors are showing more concerns with inflation and rising yields and their negative impact on long duration assets, with XLK losing 18.7% through 14 March, compared with a loss of just 1.7% for XLU.

Investors' inflation expectations were, in fact, met with the February readings of year-over-year CPI (7.9%), the highest since January 1982, and PPI (10%), the highest in over a decade. With these data points in hand, the Federal Open Market Committee (FOMC), as expected, announced on 16 March an increase in the target for the federal funds rate of one-quarter of a percentage point to a range of 0.25-0.50%. Forecasts submitted by FOMC participants in advance of the meeting indicated that all participants expected several rate hikes this year.

Figure 2

**ETF NAV (with dividends and fees) performance and 10 treasury yields**

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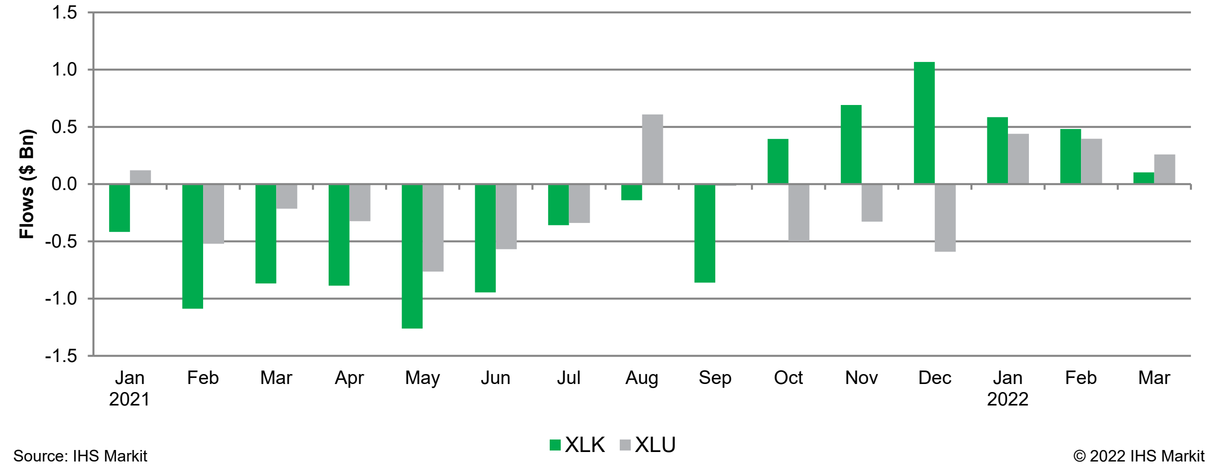
Cumulative flows into both sector ETFs (Figure 3) also clearly point to an investor preference towards Utilities over Technology in recent months, underscored by a $1.02 Bn inflow into XLU in January compared with an outflow of $0.5 Bn outflow from XLK. Furthermore, the recent IHS Markit Investment Management Index™ (IMI) survey, based on 1-5 March 2022 data from a panel of 100 institutional investors employed by firms which collectively represent approximately $845bn assets under management, identified that the biggest positive shift in sector sentiment over the past month was recorded for utilities. However, while risk appetites slumped to a new survey low as the Ukraine crisis added to inflation and monetary policy worries, Utilities still only retain a neutral position in the ranks, whereas technology returned to favor for the first time since December. Thus, in the next section we take a closer look at the technology sector for signs of positive attributes within segments of the sector during its recent downturn.

Figure 3

ETF cumulative flows

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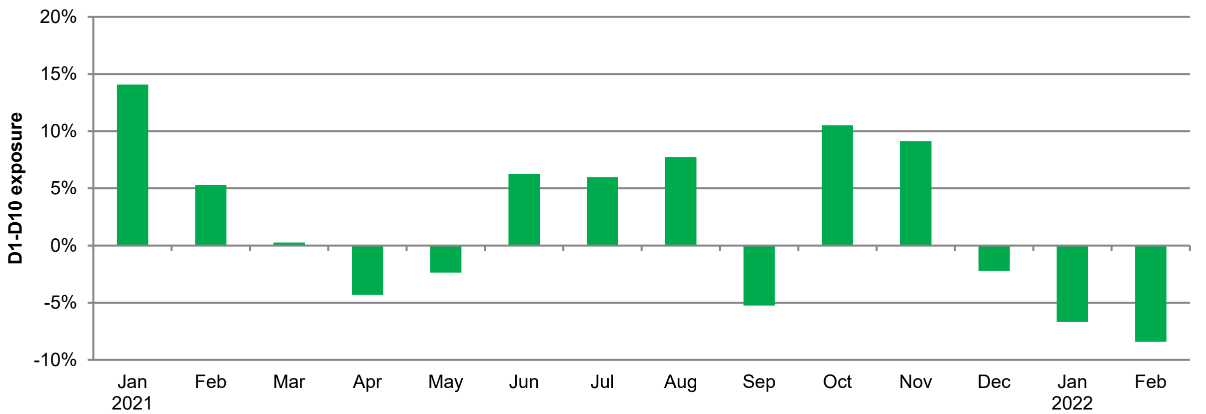
## Identifying positive technology sector factor attributes

Disfavor with the technology sector started to pick up in December, as confirmed by active sector exposures to our 52-Week High factor, ranked to favor firms trading closest to their annual highs. More specifically, focusing on rankings across our US Total Cap universe (approximately 3,000 names), we compute the percent of stocks in each sector in the top (D1) and bottom (D10) deciles to arrive at the active (D1-D10) sector exposure. We indeed find that over the last three months (Figure 4), the technology sector has experienced an increasing number of stocks falling to the bottom decile of stocks trading furthest from their 52-week high compared with stocks in the top decile.

Figure 4

52-Week High active Technology sector exposure

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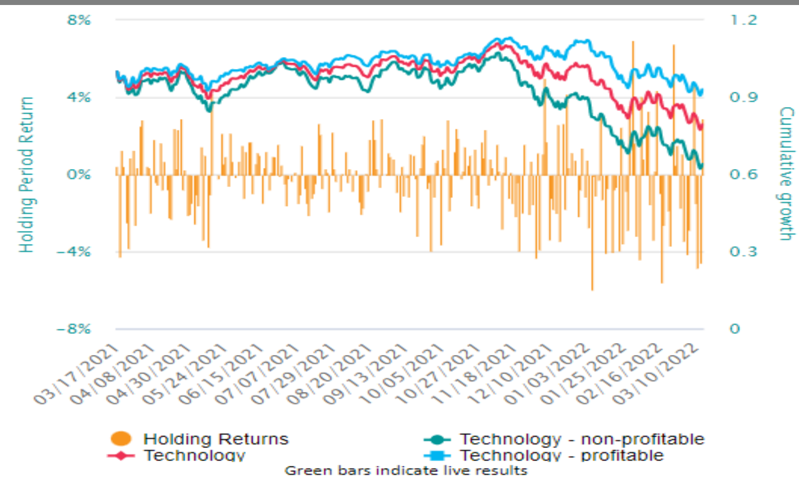
Next, we use our Stock Screener to look beneath the turmoil in the technology sector for indications whether this was a broad sector selloff or more selective in nature. First, we filter for stocks which have been profitable (258 stocks) versus nonprofitable (217 stocks) based on the firm's trailing 12-month earnings before extraordinary items. We find that performance of the two groups tracked fairly closely during the strong period for technology shares in 2021 (Figure 5). However, by December, performance started to diverge, resulting in a spread in cumulative performance over the past year of 29 percentage points through mid-March in advantage of the profitable firms.

Figure 5

**Technology sector return comparison of profitable firms**

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This leads us to further analyze high quality firms based on their Return on Invested Capital (ROIC). This factor has been a strong performer recently, posting a positive information coefficient (IC) in 11 months since the start of 2021 (Figure 6). In this case, we use the IC to gauge performance given its cross-sectional representation of signal strength as a measure of the rank correlation between factor scores and subsequent 1-month returns, rather than the tail performance encapsulated in the more commonly used decile spread return which may have sector biases.

Turning to our Stock Screener once again, we now filter for technology stocks which reside in the top 20% (Q1) of ROIC ranks (107 stocks). Over the past year, this group of high quality names has outperformed the broader sector by 14.6 percentage points (Figure 7).

Figure 6

**Return on Invested Capital ICs**

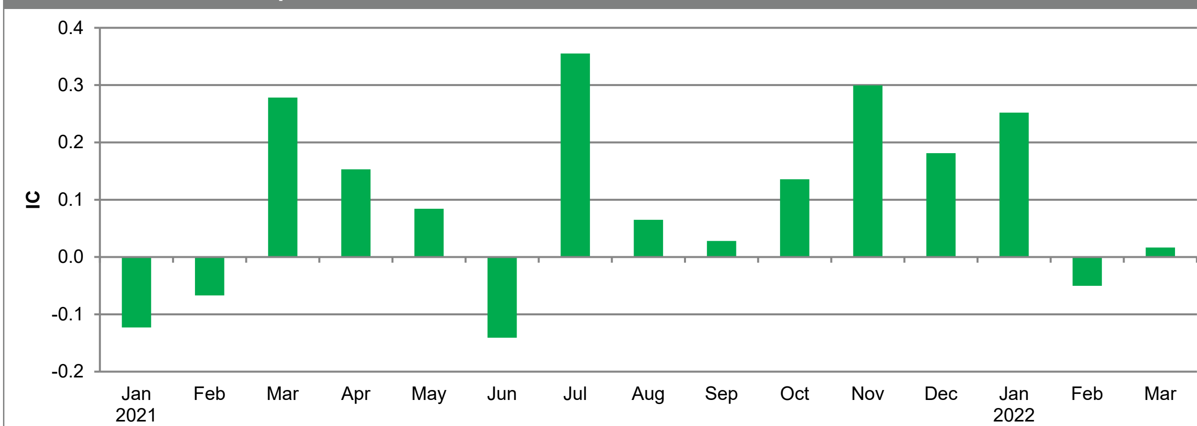


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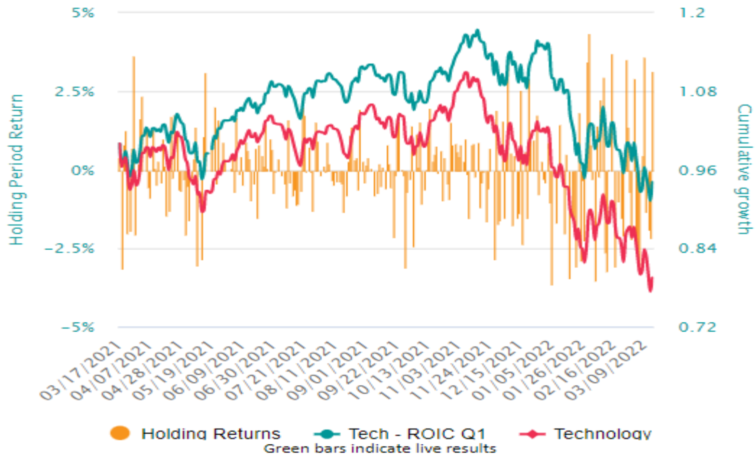
Figure 7

**Technology sector return comparison of high quality firms**




Source: IHS Markit

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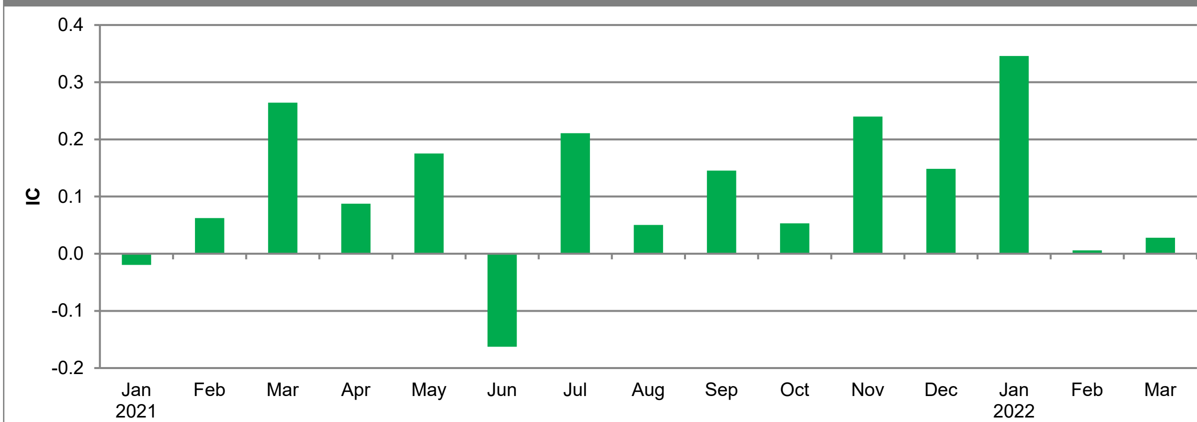
Lastly, while technology stocks are more commonly evaluated for their growth potential, we round out our analysis with a focus instead on valuation measures, considering signs of a style regime shift as value investing regained traction in the second half of 2021. In this case, we use TTM Free Cash Flow-to-Enterprise Value as our preferred measure of value for this study rather than the standard price-to-earnings (PE) ratio which is more prone to earnings manipulation compared with cash flow statement measures.

TTM Free Cash Flow-to-Enterprise Value identifies attractively valued cash rich firms and has been a highly successful signal since January 2021 (Figure 8), posting a positive IC in all but two months. The subset of stocks passing a screen for the top quintile of this measure (43 stocks) did not keep pace with the broader sector for most of 2021. However, they held up quite well during the technology selloff in 2022 and have subsequently outperformed the sector by 12.2 percentage points over the past year.

Figure 8

**TTM Free Cash Flow-to-Enterprise Value ICs**




Source: IHS Markit

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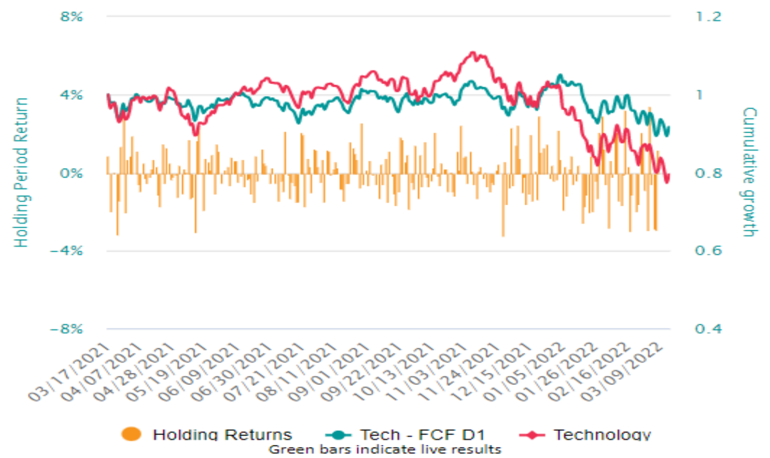
Figure 9

**Technology sector return comparison of high free cash flow firms**




Source: IHS Markit

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We conclude that in the midst of the recent technology sector rout, investors did not indiscriminately sell off all shares. On closer inspection of technology stock attributes, we find significant differences in investors’ preferences for profitable firms beginning in December 2021. During this same period, high quality firms characterized by attractive ROIC and free cash flow yield also outperformed the broader sector.

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