Allianz Global Investors

Allianz Cyber Security

Monthly commentary

Investment Objective

The Fund aims at long-term capital growth by investing in the global equity markets with a focus on companies whose business will benefit from or is currently related to cyber security.

What Happened in August

August was a volatile month for global equities. Wall Street's "fear gauge", the CBOE Volatility Index, hit a four-year high of 65 early in the month when stocks suffered a steep sell-off as weaker-than-expected US job growth sparked recessionary fears in the world's largest economy. This was followed by a swift rebound as subsequent data confirmed these fears were likely overblown. On balance, global stocks closed the month slightly higher. At a sector level, Energy stocks were the weakest while companies in sectors that are seen as defensive (Health Care and Consumer Staples) or bond proxies (Real Estate) outperformed.

Recessionary fears resurfaced when the US economy added just 114,000 jobs in July, far weaker than the expected 175,000. Additionally, U.S. job growth for the 12 months to March 2024 was revised down by 818,000. The data boosted hopes that central banks would pivot to a more dovish stance, a view that was reinforced by positive news on inflation. In July, US inflation fell below 3% for the first time since March 2021, while euro-zone inflation declined to a three-year low of 2.2%.

Within technology, the MSCI ACWI Information Technology Index posted a modest 1.4% gain with all industries advancing for the month. Results were led by mid-single-digit increases in communications equipment and IT services, while semiconductors notched only a small gain for the month. The ISE Cyber Security Index was higher by 2.5%, led by a rally in an infrastructure software maker due to a strong upside earnings surprise, while a provider of IT, security and compliance solutions, declined after lowering their revenue guidance.

AUGUST 2024

Performance Analysis

The Fund posted a single-digit advance in August, outperforming the broad-based MSCI ACWI Information Technology Index on a net-of-fees basis thanks to a combination of allocation decisions and favourable stockpicking. For the month, strong bottom-up picks in the software industry contributed to results, followed by a sizeable underweight in semiconductors, which trailed broader technology peers on valuation and supply concerns. Meanwhile, bottom-up selections in IT services offset results as did selections in technology hardware storage stocks.

On a relative basis, our active allocation to the afore-mentioned infrastructure software maker contributed to results, followed closely by above-benchmark exposure to cyber security pure plays Palo Alto Networks Inc. and CrowdStrike Holdings Inc., which both posted double-digit gains.

Conversely, our positions in an independent enterprise identity management platform; a trust and visibility software supply chain platform; and a provider of data security analysis, cloud computing and monitoring solutions detracted from results as all three stocks were lower following weaker-than-expected earnings outlooks and a moderation in investor sentiment.

Contributors

The afore-mentioned CrowdStrike Holdings Inc., which saw headlines from a security incident which led to severe outages globally and one of the largest IT mishaps in recent history, rebounded meaningfully in August. CrowdStrike Holdings Inc. reported earnings at the end of the month which eased fears over the impact with which clients may reconsider their exposure to the company. Instead, CrowdStrike is forecasting a moderation in growth for the next two quarters due to incentives and payouts to customers and will likely see an acceleration in revenues in H2 2025 . The company's CEO applauded the resilience of their teams, suggesting that their business opportunity and reputation are unlikely to be notably impacted by mid-July incident. The company also announced a platformisation strategy which may be viewed as a good strategic decision, particularly with investors lowering their expectations for the next two quarters. We added back to our position in August, after proactively reducing exposure immediately following the incident last month in an effort to manage the risk profile of the portfolio, following greater confidence in the near-term opportunity set and we continue to believe that CrowdStrike is one of the most compelling stories in the cybersecurity space thanks to industry leading solutions.

Shares of the afore-mentioned infrastructure software maker that integrate multiple areas of security, rallied following better-than-expected results point to a sequential acceleration in both its product and services segment sales. Overall, investors have been skeptical of the company's ability to deliver results, with this robust earnings announcement translating to a rebound in sentiment. We added to our position during month due to improved fundamental factors and a better near-term growth versus valuation mix.

Shares of Palo Alto Networks Inc., a leading network security provider, advanced following strong quarterly results with revenue upside and margin expansion translating to a solid earnings beat as the company's platformisation strategy has been paying off. Palo Alto was the largest holding in the portfolio thanks to its thematic purity, strong management team and attractive growth runway.

Our positions in cyber security pure plays Cyberark Software Ltd. and Zscaler Inc. also contributed to absolute performance in August.

Detractors

Our largest absolute detractor for the month was the afore-mentioned trust and visibility software supply chain platform. The company announced a lower-than-expected earnings guidance, citing macroeconomic pressures from small and medium-sized businesses. We continue to have conviction in the company's longer-term potential and their valuation level is at attractive levels.

Similarly, the afore-mentioned independent enterprise identity management platform declined following earnings results which pointed to lower-than-expected revenue acceleration amid saturation in larger accounts and moderation in new client growth. We made the decision to reduce our exposure to the stock due to concerns that future growth may continue to disappoint in light of macroeconomic uncertainty and to increase exposure to companies with better near-term catalysts.

Shares of a provider of data security analysis, cloud computing and monitoring solutions, declined after the company's revenue forecast disappointed investors due to an elongated sales cycle. We continue to hold the stock for its secular growth opportunities particularly as it relates to AI-related applications and the wide applicability of the company's platform.

Our exposure to a hardware, software and data centre provider and an infrastructure software solutions provider also offset absolute performance for the month.

Purchases and Sales

Turnover in August was at a slightly elevated level due to a slew of earnings results and overall market volatility, which resulted in repositioning across select names. We newly purchased shares a provider of custom information technology consulting and technology services, amid stabilising trends which is likely to drive margin improvements through effective cost management.

We also added to multiple existing names in the portfolio. Our weight in the afore-mentioned security pure plays CrowdStrike Holdings Inc. and the afore-mentioned infrastructure software maker increased following earnings results which increased our conviction in both companies and the ability to execute their network security solutions strategies.

We increased exposure to a data solutions support provider, following a new buy in July, as we continue to build our position given expectations that the company can take market share via the implementation of AI to improve data visualisation and provide better analytics.

We also added to perimeter network provider Check Point Software Technologies Ltd, a communications equipment maker, and an infrastructure software platform given their attractive growth versus valuation profiles and potential to build momentum following recent earnings results.

We funded these trades in part through the sale of the afore-mentioned hardware, software and data centre provider and a data storage devices and solutions provider, amid concerns that the personal computer (PC) cycle may continue to disappoint and in order to lower our cyclically-oriented exposure.

We also fully exited a maker of computer-memory chips, a semiconductor equipment producer and a chip design software maker in an effort to reduce our overall exposure to semiconductors. In addition to these full exits, we trimmed multiple names to augment the risk versus reward profile and incrementally focus on higher conviction alpha opportunities. This included reducing our weight to the afore-mentioned identity management platform, an online retail and cloud computing giant, as well as three application software providers.

Market Outlook

We continue to have a constructive mid-to-long-term outlook for equity markets, particularly cyber security given its secular growth outlook, and believe that volatility may be heightened in the short-term amid a less certain macroeconomic backdrop and what appears to be a closely contested US presidential election in early November. Investors remain increasingly fearful of a deeper economic slowdown and late timing of interest rate cuts, given recent softer employment numbers, economic indicators as well as consumer spending trends, and look for an interest rate cut in September to help improve sentiment.

We have seen strong quarterly earnings results from the majority of cyber security stocks. While this sub-asset class has lagged broader technology market from mid-February onward, we believe this is set to reverse course due to improving investor sentiment and the upcoming seasonally strong quarters. Our expectation is that merger and acquisition activity may rise as capital markets continue to show signs of strength, and there is potentially a broad cross-section of acquirers for cyber assets given their durability and strategic positioning. Additionally, valuations remain attractive with cyber companies broadly trading at pre-Covid levels on an enterprise value to sales ratio and cyber remains one of the more insulated areas within technology which is less likely to be impacted by any boom and bust spending which has been impacting AI-related opportunities in the last couple months.

Despite short term periods of higher volatility among technology stocks, earnings growth ultimately drives stock prices over the long term, and in our view, we are still early in the spending trend supporting this dynamic segment. We are excited about the investment opportunities presented, and believe our research-driven, bottom-up process is the most effective means to capture the value generated by this theme.

All data are sourced from Bloomberg and Allianz Global Investors as of 31 August 2024 unless otherwise stated.