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 May

Global equities advanced over May with US stocks leading the rally, boosted by a jump in Technology companies, particularly graphics processors and related software maker Nvidia which blew past earnings' forecasts. In contrast, Japanese and UK shares rose only modestly, while the MSCI Emerging Markets Index was pressured by weak returns from Brazil and Mexico, among others. At a sector level, Information Technology (IT) rallied the most, with Communication Services and Utilities also areas of notable strength. Meanwhile, Energy was the only sector in the MSCI All Countries World Index to fall over the month.

In the US, the US Federal Reserve (Fed) Chair Jerome Powell signalled that investors would need to be "patient and let restrictive policy do its work" in reducing inflation. However, he also confirmed that the likelihood of a further increase in rates was "very small". In the eurozone, the European Central Bank (ECB) gave its strongest hint yet that rates would be cut in June, despite higher-than-expected wage growth. Hopes that the Bank of England (BoE) would also cut rates in June were dashed when UK inflation fell less than forecast and the government unexpectedly called a general election to be held on 4 July.

Within Technology, the MSCI ACWI Information Technology Index advanced 8.0% for the month, thanks to double-digit gains in semiconductor and technology hardware industries, while IT services was the only industry to post a loss for the month. The ISE Cyber Security Index was lower by 0.9% in May, with a legacy antivirus and firewall provider contributing to performance following earnings results and a change in leadership, while global content delivery network provider Cloudflare offset performance following a weaker-than-expected guide.

Performance Analysis

The Fund posted a decline in May, trailing the broad-based MSCI ACWI Information Technology Index, primarily due to a continuation in short-term sentiment and divergent industry returns. For the month, a below-benchmark exposure and positive stockpicking in electronic equipment instruments contributed to results. This was offset by above-benchmark allocations and short-term stock selection within software and IT services industries, two of the benchmarks relative laggards for this month. Our below-benchmark exposure to semiconductor stocks, the benchmark's top industry performer for the month, also offset results given our focus on thematic purity which translates to the avoidance of legacy memory providers as well as a structural underweight to select mega-cap names which led benchmark gains during the month.

On a relative basis, our avoidance of three companies within the broader MSCI ACWI Index contributed to results for the month. The decision not to own a Korean consumer and communications equipment giant was lower despite improving profits and incremental demand for artificial intelligence-related (AI-related) applications; a financial management software maker declined following lacklustre earnings and a weaker-than-expected guide; while a diversified software and creative content provider continued to moderate post the company's generative-AI boom in late 2023 and early 2024.

Meanwhile, our active underweight allocation to Nvidia offset results due to the continued surge in shares following robust earnings results and durable guidance, combined with its sizable benchmark weight. Our above-benchmark exposures to two cyber pure plays including Cloudflare Inc. offset results given their muted guidance, combined with the overall headwinds in software companies relative to semiconductor and technology hardware providers.

Contributors

Nvidia, which offset relative results given its outsized performance and double-digit benchmark weight, continued to contribute to absolute results in May. The stock remains a beneficiary from resilient demand for chip, data centre and AI-related applications, where the company has an undisputed dominance in the marketplace. We continue to have a favourable viewpoint on the stock and remain limited in terms of expressing this viewpoint given the position size limitations in the Fund, desire to focus on cyber security pure plays and in order to provide diversification across other names in the portfolio.

Shares of CrowdStrike Holdings, a cloud-based security solutions which build around the company's endpoint detection and response platform, contributed to results thanks to growing partnerships and steady adoption of their add-on products, which is translating to expectations of steady recurring revenue growth. The stock remains one of the largest holdings in the portfolio, thanks to its industry-leading product suite and an attractive growth versus valuation mix.

Our exposure to enterprise software, cloud and cyber security giant Microsoft Corporation also aided returns during the month, as select diversified mega-cap technology companies continued to garner investor attention in light of the recent macroeconomic softness.

Our positions in a cloud networking solutions provider, and a computer hardware and storage maker also contributed to absolute results in May.

Detractors

Our largest absolute detractor for the month was Cloudflare Inc., which aims to speed up websites by placing cloud servers closer to customers and designed to provide more secure, private, fast, and reliable connections. Although sales and earnings results topped consensus, the company's revenue guidance was seen as ultra cautious, with management pointing to macro uncertainty which could impact customer buying behaviour. Our belief is that the new transition on the sales and executive side should deserve the benefit of doubt, but we are actively monitoring the potential moderation and growth and the company's ability to execute and deliver. We continue to hold the stock given our favourable long-term viewpoint.

Similarly, shares of a best-of-breed next-generation endpoint detection and response leader posted strong upside earnings results while forward guidance disappointed the market. The company remains well positioned to continue to take endpoint market share, expand into adjacent markets, and deliver strong growth with improving fundamentals.

A document database provider, which allows to store structured or unstructured data to make development of applications more agile, declined following a weak outlook combined with overall headwinds in software names.

Our exposure to a cloud-based data monitoring and analytics platform, and a software development company also offset absolute performance in May.

Purchases and Sales

Turnover was lower than average in May, as our belief is the portfolio was well-positioned from a fundamental and materiality standpoint and given our preference to not potentially overreact to recent market volatility, particularly in software and IT services stocks, which could impact future performance outcomes. There were no new buys in the portfolio during May. We made the decision to add to a handful of names based upon their near-term alpha versus risk profile, including a cloud software intelligence platform which was incrementally more appealing following an expectation reset and an attractive valuation; an electronics components maker which remains a beneficiary of outsized AI and data centre demand; and a semiconductor maker due to industry strength and momentum around their cutting-edge products. These additions were funded in part via the sale of an IT services provider, which has struggled amid a moderation in demand as companies are being more selective about IT spending budgets.

We also trimmed our exposure to an infrastructure software maker due to expectations of a weaker pricing environment which may limit growth, and a communications network equipment maker in favour of companies with a better risk versus reward balance and more favourable growth potential.

Market Outlook

The Fund trailed broader technology benchmark in May, echoing the impact from to short-term industry and market cap exposure over the last few months. Our confidence in cyber-related companies remains robust and our viewpoint is that the recent performance results are likely to subside as market expectations have been somewhat reset, with valuations trending lower and long-term demand for cyber solutions remaining high. Our exposure software and IT services pure plays have lagged due to their interest rate sensitivity given a more hawkish Fed outlook amid inflation and US election which is likely to delay rate hikes. Similarly, our greater emphasis on mid-caps, which has been a key contributor to performance over time, has trailed due to their greater interest rate sensitivity and investor preference for select mega-cap names.

Cyber earnings results have been broadly positive, and forecasts continue to be healthy although forward guidance is perhaps lower than lofty sell-side expectations. It is important to note that the recent reporting quarter is seasonally slow due to IT spending cycles which favour the back half of the year. We saw a similar pattern of a slow relative start for cyber stocks compared to broader technology peers in early 2023, which reversed course in H2. Our viewpoint is that this playbook may continue this year as well.

We remain optimistic that continued enterprise investment into cyber security may yield double-digit growth and AI adoption is likely to fuel further investment as companies look to defend against improving capabilities from adversaries. In addition, companies are looking to create efficiencies from use of AI with cyber products, including threat detection and to automate mundane tasks, which also helps address the understaffing globally. Our expectation is that the mergers and acquisitions (M&A) environment is likely to accelerate for both public and private companies. Valuations remain reasonable and we believe there is ample room for estimates to increase which should be the primary driver of performance over the course of the year.

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 May 2024 unless otherwise stated.

Allianz Global Investors and Voya Investment Management (Voya IM) have entered into a long-term strategic partnership, and as such, as of 25 July 2022, the investment team transferred to Voya IM and Voya IM became the delegated manager for this fund. AllianzGI continues to provide information and services to Voya IM for this investment through a transitional service agreement.