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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 October

Global equities mostly ended October lower. Japanese stocks were a rare bright spot, advancing on hopes of higher government spending after the ruling Liberal Democratic Party lost its parliamentary majority for the first time in 15 years. Elsewhere, however, early gains were more than offset by a weak close to the month. At a sector level, Health Care, Materials, Consumer Staples and Real Estate fell the most, while Financials, Communication Services and Energy moved higher.

With economic data continuing to indicate a soft landing for the US economy and a solid jobs market, expectations grew that the US Federal Reserve (Fed) may slow the pace of its rate cuts. In Europe, the European Central Bank (ECB) lowered interest rates by 25 basis points (bps), marking its third cut of this year. The People's Bank of China (PBoC) also reduced its 1- and 5-year loan prime rates by 25 bps. The rates are used as a reference point for most loans and mortgages in China.

Within Technology, the MSCI ACWI Information Technology Index declined 1.0% as modestly positive results in communications equipment and semiconductors stocks were offset by performance within information technology (IT) services, technology hardware and software industries. The ISE Cyber Security Index declined 0.3% for the month, with software and security solutions developer Cloudflare Inc. rallying to new all-time highs, while an anti-virus software maker declined after outsized gains in the prior months.

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Performance Analysis

The Fund posted a low single-digit advance in October, outperforming the broad-based MSCI ACWI Information Technology Index, thanks to positive stockpicking. Results were led by strong bottom-up gains in the software industry, followed by performance in IT services stocks. Meanwhile, a below-benchmark allocation and more conservative short-term selections in semiconductors detracted from monthly performance.

On a relative basis, our active allocation to a cloud data management and data security provider, and security and content delivery network services leader Cloudflare, Inc. contributed to results, as did our meaningful below-benchmark weight in an enterprise software, cloud and cyber security giant.

Conversely, our avoidance of a graphics processing and related networking leader, and a chipmaker detracted from relative results, given their positive results and sizable benchmark weights, while our active exposure to a leading cyber security solutions provider also offset relative results in October.

Contributors

The aforementioned cloud data management and data security provider – a platform focused to help enterprises achieve resilience against cyber-attacks, malicious insiders, operational disruptions, cloud mobility, and regulatory compliance – aided results in October. The company, which had its initial public offering at the end of April, was higher despite little in the way of new news, with the sell-side becoming increasingly positive on their earnings potential amid a backdrop of data growth, the shift to the cloud and secular growth of security. We continue to hold the stock given its attractive risk versus reward profile.

Shares of Cloudflare Inc., a provider of technologies to improve traffic management, computing, programmability, and security, advanced in part to the appointment of a new president of product and engineering, which is anticipated to help the company accelerate growth in the coming quarters. Additionally, the company's expanded sales force is likely to drive incremental growth, thanks to improved sales productivity and a focused go-to-market strategy. The stock remains a top 5 position in the portfolio given its thematic materiality and growth potential.

Our allocation to cyber security solutions leader Palo Alto Networks, Inc. contributed to results, thanks to the company's strong leadership position, their platformisation strategy and rebound in software-related names. The company remains a top position in the portfolio due to its materiality and attractive risk versus reward.

Our position in a big data and analytics software solutions provider, and infrastructure software provider SentinelOne, Inc. also contributed to absolute performance in October.

Detractors

Our largest absolute detractor for the month was the aforementioned cyber security solutions provider, with roots in appliance-based firewalls that protect corporate networks from security threats, which was lower following disappointing earnings results. The company's longer sales cycle and weakness in billings show some competitive pressure, even with the company offering flexible payment terms, which impacted near-term sentiment. The stock had been a steady performer in advance of the earnings print, thanks to its growth at a reasonable valuation profile, and we made the decision to trim our exposure in favour of companies with better near-term catalysts.

Shares of CyberArk Software Ltd., a provider of identity and access management security tolls to protect against unauthorised access, declined for the month despite incrementally improving street analyst expectations and favourable channel checks. Instead, the stock pulled back from all-time highs as investors appeared to wait for clarity with the upcoming US elections, as well as earnings results from the company, due the first week of November. We continue to hold the stock thanks to its leadership position and favourable alpha versus risk profile.

Our position in the previously mentioned enterprise software, cloud and cyber security giant detracted from results as the company announced earnings, which pointed to outsized growth in their cloud services unit, was offset by a lower forward guidance amid capacity and moderating growth headwinds. The company appears well positioned in key secular growth markets and we will remain at a material underweight given the stocks sizable weight in the benchmark, combined with expectations of better pure play and cyber-related catalysts from other companies in the investment universe.

Our exposure to a designer and developer of data security software solutions, and a producer of semiconductor products and devices, also offset absolute performance for the month.

Purchases and Sales

Turnover in October was at a lower-than-typical level, reflective of the near-term uncertainty around the US presidential election, combined with a period before earnings results are just about to kick off for the majority of companies in the portfolio.

We newly purchased shares of a provider of integrated internet traffic management and security solutions, with the company benefitting from external demand improvement as enterprise customers move forward with infrastructure upgrades in order to prepare for artificial intelligence (AI) applications/solutions. We also added to a few existing names in the portfolio, including a database and infrastructure software developer; an AI-hardware and software solutions provider; and security platform SentinelOne, Inc., based upon their near-term alpha versus risk profiles.

There were no new sells in the portfolio for the month and these trades were funded in part via the trim in several existing companies. The largest trims came from the software industry, led by profit-taking in the aforementioned big data and analytics software solutions provider, as well as trims in the previously mentioned cyber security solutions provider; the enterprise software, cloud and cyber security giant; and Zscaler Inc., given expectations of companies with better near-term alpha potential. We also trimmed exposure to the aforementioned producer of semiconductor products and devices, and Broadcom Inc., in an effort to reduce our exposure to semiconductors and increase the overall materiality of the cyber security portfolio.

Market Outlook

The near-term outlook for cyber security-related companies continues to look increasingly attractive, thanks to expectations of additional rate cuts, seasonality of demand and the potential for a catch-up trade following relative performance for the last couple quarters. These expectations may be further cemented with results of the US presidential election, which is likely to give greater clarity to markets regardless of the outcome.

Our expectation is that mergers and acquisitions (M&A) activity may continue to 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 that is less likely to be impacted by any boom/bust spending which has been impacting AI-related opportunities in recent months. Amid any potential volatility, we are opportunistically looking to upgrade select names and add to our highest conviction ideas to better position the portfolio for improved performance. We continue to have a constructive mid-to-long term outlook for equity markets, particularly cyber security stocks given their secular growth expectations.

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.

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