Kepler | Investment Companies Research

13th July 2010

Non-independent research

Update report:

RCM Technology Trust PLC

Sector:	Technology	Price @ 08/07/10:	272.5p
Ticker:	RTT.L; RTT LN	NAV @ 08/07/10:	301p
Mkt Cap:	£62m	Discount @ 08/07/10:	-10.2%
Total Assets:	£70m	Discount (1 yr ave.):	-9.5%

Summary

RCM Technology Trust (RTT) has outperformed its benchmark and investment trust peer group since Walter Price's team took the reins in April 2007. With the technology sector increasingly in focus, in this note we provide an overview of the trust and an interview with the manager.

Solid performer looking good value relative to peer

- The trust has been a solid performer and the discount has broadly remained within the board's single figures target. For the first time since Walter Price (and the team at RCM in California) started managing the trust, RTT is now better value than Polar Capital Technology Trust.

Attractive entry point, with strong growth expected from underlying companies

- Technology, in Walter's view, will be an important element for portfolios, able to provide growth in a world where growth will be fairly absent over the next three years. Current valuations are very far from being stretched, and he expects durable earnings growth numbers significantly ahead of current P/E ratios.

Experienced team, on the front line

- Walter has been analysing technology stocks for over thirty five years. He and the seven other members of the team are based in California which in his view enables them to pick up early on emerging technology markets, new products and trends. In their view, their long-term track record has been build on identifying trends and the leaders within them relatively early, and owning them for an extended period of time.

Four main themes – internet, cloud computing, china and smart energy use

- The team's key current themes are the internet, within which the team believe media, shopping and search (advertising) are all on a secular uptrend. Cloud computing is another central theme, with the team anticipating a seismic shift in how business computing is done. The fund has a small (max 10%) allocation to China. The last (broad) theme in the fund is energy conservation, solar energy production and energy control. Walter believes "smart" technologies that enable increased power efficiency and savings will be key beneficiaries of his "big problems create big opportunities" philosophy.

Actively managed portfolio with mid-cap bias

- The team actively managed the portfolio of around 70 stocks through the period of severe risk aversion seen in 2008, and have now positioned the portfolio towards mid-cap growth stocks. Turnover remains high by traditional standards at c.100%, which Walter claims is driven mostly from trimming or adding to positions if valuations move dramatically.

Walter's consistent outperformance of the benchmark, together with the demonstrably stable discount (currently c.10%), makes RCM Technology an interesting specialist vehicle for investors looking for growth. The team have considerable expertise and experience, and the portfolio remains highly differentiated from the benchmark and peers.

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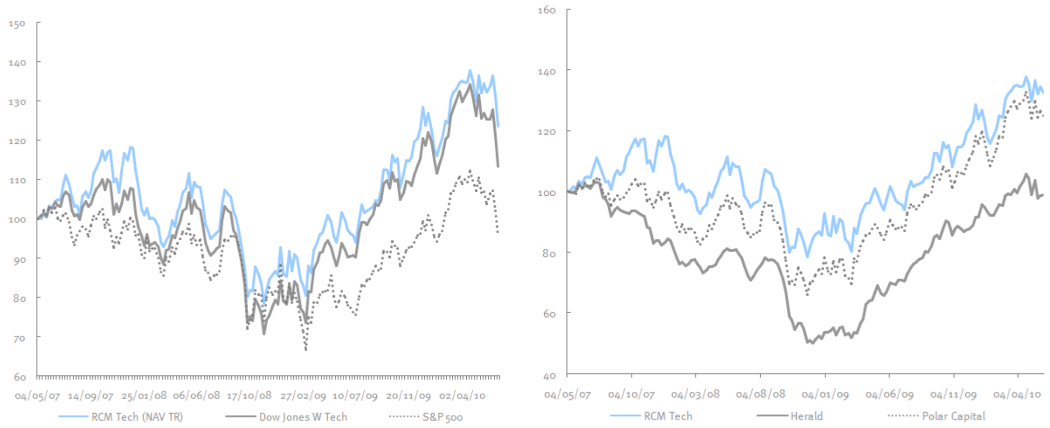
Background

RCM Technology Trust has been managed by RCM, under Walter Price, since 30 April 2007. Its objective is to generate long term capital growth through investment on a worldwide basis in large to mid cap quoted technology companies. Walter has a team of seven portfolio managers and analysts all dedicated to the Technology sector. Walter joined RCM in 1974, and has managed Technology portfolios since 1985.

As figs. 1& 2 illustrate below, performance since the RCM team took over as managers of the trust has been strong in absolute terms. The trust has also beaten both the benchmark and investment trust peers over the period.

FIG 1 & 2: PERFORMANCE REL. BENCHMARK AND S&P 500, AND REL.INV TRUST PEERS



Source: Morningstar

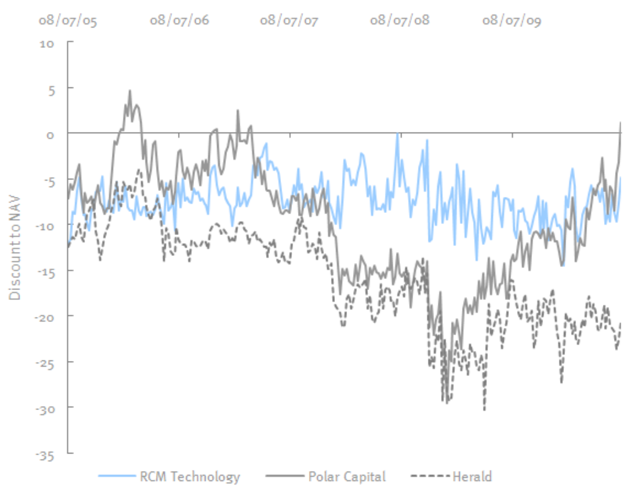
FIG 3: PERFORMANCE RECORD RELATIVE TO PEERS AS AT 8TH JULY 2010

	1 mth	rank	6 mth	rank	1 year	rank	3 year	rank
Herald	3.4	1	5.4	1	43.7	1	-1.9	3
Polar Capital Technology	-1.9	3	0.7	3	38.2	2	16.2	2
RCM Technology Trust	-1.4	2	1.3	2	36.8	3	18.6	1

Source: Morningstar / Kepler Partners

The board have a discount control mechanism which has meant that the trust's rating has remained broadly stable and in single figures. For the first time since RCM started managing the trust, it is now better value than Polar Capital Technology Trust (PCT).

FIG 4: 5 YEAR DISCOUNT HISTORY RELATIVE TO PEERS



Source: Morningstar

Interview with Walter Price

We recently met up with Walter to understand more about the Technology sector and establish what he is most excited about with regard to the positioning of the fund.

We reproduce an edited version of our conversation:

Why should investors have an allocation to technology in their portfolio?

Technology has the ability to create new markets and new low cost ways of doing things. It offers the prospect of strong growth in a world which isn't going to see much growth. The reason you buy it now is that you can get this growth at a reasonable valuation, and we are on the cusp of what I think are going to be some major changes in the way the world does business. Cloud computing, for example, is going to be worth hundreds of billions of dollars for a concentrated group of winners which is a great opportunity for investors. Amazon could eventually become as valuable as the non food portion of Wal-Mart, with huge economies of scale available from their very dominant position.

What are valuations like at present?

The Tech sector represents around 17% of the S&P, the largest constituents of which (including Google) are really very cheap. I'm not looking for valuations to expand in order to make money from the holdings I own; I am expecting appreciation from the earnings growth. A lot of these growth rates are very durable. The health of the rest of the world economy is obviously very important, but my scenario is that where expectations will be sorted out over the next month or so, and we will find out that the European area isn't as bad as US investors expect, or that China isn't as bad as investors think. When investors discover that people are still spending money on technology projects people will feel a lot better about technology stocks.

Overall, I am quite happy with valuations. Over the past year, cloud computing companies continued to grow through the recession whilst the older, larger ones contracted. This reminds me of the early 1990's. Many of the new wave companies such as Microsoft and Dell went through the recession still growing, perhaps slowing down, but still growing. This contrasted with the larger companies, such as IBM, which were shrinking and having issues. We are about to go into that turmoil again, where the emerging companies are going to keep growing but the larger ones are not and then the leadership is going to switch. Microsoft and Oracle have huge maintenance businesses that will continue to service clients and generate huge amounts of cash for the companies. IT directors will not be adopting cloud computing straight away – particularly larger companies distrust it at the moment. I don't think the incumbents will fall a lot from the current valuations; it's just that I don't think they will go up a lot.

Why is it important to be located, as you are, near the action?

What we've seen over the past years is that new concepts in software and hardware are being pioneered in the San Francisco bay area. I call it the "rainforest effect" – a whole ecosystem entirely devoted to technology. Part of the reason is that there is a very vibrant Venture Capital industry there with a lot of money available. There is also a culture of a willingness of employees to try new things and go into new ventures without worrying about job security. A lot of them have worked for start-ups before and as the start-up becomes more successful and larger, it is relatively easy to bolt on new personnel that can continue to help drive the growth and make sure that the success is built on.

As a team we are constantly exposed to the companies and the exciting events within them. Who is hiring, who is successful and why? We can much more easily gauge what people are excited about in terms of emerging markets, products and trends. Our long term performance record has really been about finding these trends relatively early on, identifying the leaders and owning them for an extended period of time.

What are the key themes reflected in your portfolio?

Our philosophy rests on finding and investing into disruptive innovation. We have several main themes at the moment: the internet, cloud computing and a wider theme of energy infrastructure.

- The **internet** is about 25+% of the portfolio. The internet is a very dynamic area with a lot of growth. We believe that internet media, shopping and search (advertising) are all on a secular uptrend. Google is really starting to monetise YouTube and it is increasingly managing to turn Android into an asset. Both of them could add say 25% each to Google's valuation, on top of whatever search could do in terms of adding value. Google is the primary threat to Apple. It is possible to hold them both at the current stage (as I do), but if I do worry about something with Apple it is that it has been here before and given it all away. Will the mobile world go the same way as the PC world did? I'm old enough to remember when Apple owned the PC business and lost it all in the 1990's because it was considered a closed system and all the innovation happened on another platform. Apple is a lot smarter now and they are doing a lot of things with iTunes to hold that business. However, Google have a lot of hungry European and Asian partners who are going to embrace their operating system as a way to compete with Apple.

- **Cloud computing** is another area. This is a once in 20 year change in how computing is done. It is enabled by a lot of technologies coming together and being economical. There are going to be two phases – the first in which it is good for everyone, but in the second phase there will be a lot of consolidation where companies are buying an application and having it maintained centrally, and run off 3000 servers rather than 70,000 servers. This is going to be a big problem for the big tech companies. Microsoft is an example of a company being threatened. However, I expect it to have huge revenues over the foreseeable future which more than justify its current price. It is the application providers like Salesforce.com that will be the winners. People want to make their companies more efficient. These products provide dynamic real time company management tools which is the way people are going to do things in the future. An example of this is Salesforce.com. I also own Successfactors.com, Concur (travel expense management) and a couple of other "software as a service" companies representing around 15% of the portfolio in total.

- Another theme is **China** representing around 10% (and no more) of the portfolio. I think that is a good hunting ground. I am interested in finding the companies that will provide the IT infrastructure over there – the Chinese Oracle for example. These companies are reasonably cheap - most of these stocks (excluding Baidu) are only on a c.15 multiple and are generating cash.

- Another theme in the portfolio is all around **energy conservation, solar energy production and energy control**. I think that big problems create big opportunities. We do have a big energy infrastructure problem which is going to present a big opportunity. We are looking for companies that are part of the solution as a move away from petroleum. Around 15% of the portfolio is invested around this theme. Energy saving is the biggest sub theme – I own a whole group of companies in this category. Most of our semi-conductor holdings are energy saving plays. Most governments are realising that energy saving is the easiest way to cut down our greenhouse gas emissions. If you can mandate widespread use of LED lights and smart controls on heating, light, and air conditioning it might be possible to save up to 40% of power consumption. In a World economy which won't see much growth, I think companies in this space will see significant growth. Most of them have a market capitalisation of around $1bn, and none have a market cap of over $1.5bn. I'm sure some companies such as Samsung are going to get into this market, but they are more than likely to buy the sort of companies I am buying and own. I participated in the IPO of Tesla and then sold after the first week having made 50% which shows some of the interest that is starting to come to this area.

This is quite interesting as it is perhaps not the sort of theme that one might expect to find in a "technology" fund.

This is a reflection of the fact that I see high returns and high growth, as well as costs coming down. Electricity prices will in my view continue to rise. The cost of putting in energy saving technology is coming down rapidly and it is all enabled by electronic technology.

How have you managed the portfolio over the credit crunch and the rush to risk aversion seen in 2008, and since?

There is a dichotomy in the technology sector – between large incumbents with huge cash balances, and the smaller newer companies that might be expected to grow a lot faster. We had large positions with the former over 2008 and into early 2009, when we aggressively shifted back into the latter. I think a lot of the big tech companies are looking at the new leaders to emerge and are waiting for the next bear market to snap them up if they haven't got too big a market cap by then. As a large company, you can't buy Amazon or Google, but you could still buy Salesforce.com. In certain market environments, finding good companies doesn't matter – 2008 and 2009 were exactly these sorts of periods. However, over time I think people care about investing in companies that will grow to be large over the long term.

How much of the portfolio do you currently have in the incumbents, and how much in the new wave?
It depends how you define it. Apple has a huge amount of balance sheet cash per share, and yet it is growing at 30% per year. That's my largest holding. No one could say it's a ponderous cash cow. I've been top slicing (too early as it turns out) but it remains my largest holding. Holdings in this category are mainly Cisco at 5%, and Microsoft 2% in the top 20, so perhaps 10% in total. My feeling is that the portfolio is very different from the index, and very different from our competitors.

Is 70 holdings quite diversified for a specialist fund?
We have a range set between 50 and 100 stocks. Where we are within this range is generally set by the IPO background. Where there are lots of companies IPO'ing we head towards 100 stocks, and where there are none we narrow the focus down.

So what is the IPO atmosphere like at the moment in the tech sector?
It is a tight IPO window at the moment. There were a lot of IPO's at the beginning of 2010 which were mainly from venture capital partnerships ending, and reflecting a need for liquidity. They weren't by and large good companies, and are not the sort of companies I want to participate in. Facebook or Linked-in, for example, are the type of IPOs I'd look at, depending on valuations obviously. Tesla, as I mentioned earlier, was a successful IPO we participated in. I expected to make twice my money over a longer time frame, but was happy to sell out having made 50% in a week.

What is turnover like in the portfolio?
Turnover has been reducing, and is now around 100%. This turnover is mainly driven by trimming. I have a policy of trimming a third of a stock if it has risen faster than my expectations and is close to my near term target. I've been trimming Apple recently for example.

How far out into the future do you look out in terms of trying to anticipate future trends?
The views expressed in the portfolio go out about 3 to 5 years. Anything more than that is in my mind more "venture". We invest in companies that are profitable and are growing and have good cash flow. There are some small cap companies I watch closely, and will look to invest in when they have the right profitability characteristics and have reached a size of market cap.

How do you initiate a new theme / subsector into the portfolio?
We usually identify a new theme through a company visit which will highlight an exciting new area. We then do a lot of background research into companies with exposure to that theme. When we identified LED lights, a colleague of mine went and met with every company in Taiwan, Korea and a lot of companies in China and the US involved in LED lights. We then identify the range of investable companies and typically start with a wide range of smaller holdings in companies (so around 10 in relation to the LED theme). We then pare the holdings down as we gain confidence in which picks will prove to be the winners by watching their ability to execute their plan. Our aim is to run these winners until they are very large indeed.

How would you summarise RCM Technology Trust in one sentence?
We do the hard work for our investors by finding and owning the great growth companies and stocks in the technology sector.

Portfolio

The portfolio summary at the end of May can be seen in Fig. 5. As he mentions above, Walter has been moving down the size scale in terms of market capitalisation since Q2 2009, but he tends to stay clear of the more speculative and volatile small-cap end of the spectrum.

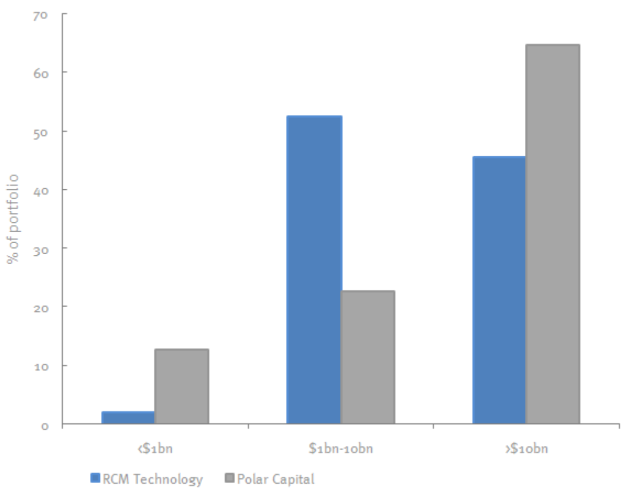
FIG 5: PORTFOLIO BREAKDOWN AS AT 28TH MAY 2010

Top ten holdings	% of portfolio	Geographical breakdown	% of portfolio
Apple	5.7	North America	77.3
Cisco	4.3	Far East & Pacific	13.8
Amazon	3.9	UK	3.0
Akamai Technologie	3.8	Europe ex UK	2.6
Salesforce.com	3.5	Cash	3.4
Google	3.3		
Netflix	3		
Baidu.com	2.9		
Successfactors	2.8		
Riverbed Technology	2.5		
Total	35.7		

Source: RCM

We believe that the portfolio is relatively differentiated in terms of type, and size, of company when compared to Polar Capital Technology Trust (PCT), the most comparable investment trust peer. Polar Capital is the most similar in terms of mandate, run by a UK team, and is currently with a larger bias towards large and small cap stocks than RCM Technology.

FIG 6: BREAKDOWN BY MARKET CAPITALISATION



Source: Morningstar

Other important details

Subscription Shares

Subscription Shares were issued to shareholders in August 2007. Each Subscription Share confers the right (but not the obligation) to subscribe for one Ordinary Share in the thirty days preceding the AGM in each year to 2012 at a price of 267p per share. They have no voting rights and no entitlement to any dividends. At the current share price of 272.5p, the subscription shares are marginally “in the money”. Ordinary share NAV’s on which discounts are calculated will include the dilution impact of these subscription shares.

Gearing / Market exposure

Gearing is not expected to exceed 10% of net assets but may at times increase to 20%. Similarly, the proportion of the Company's net assets held in cash or liquid investments will not exceed 15% of net assets but may be increased at times to a maximum of 30%.

Benchmark

The benchmark is the sterling adjusted Dow Jones World Technology Index, representing the largest technology companies worldwide, weighted on a free-float basis.

Dividend

There have been no dividends payable by the trust historically, and given the nature of the investments of the company, the board have given guidance that it is unlikely that one will be paid in the foreseeable future.

Management fees

RCM is paid a basic management fee of 1% of the market capitalisation of the trust. In addition, the manager is entitled to a performance fee of 20% of the outperformance over the benchmark. This performance fee is subject to a "high water mark" in which the manager only earns a performance fee where the NAV at the end of the relevant performance period is greater than the highest previously recorded NAV on which a performance fee was paid.

Continuation vote

Shareholders will have the opportunity to vote at the Annual General Meeting in the spring of 2011 whether to continue the Company and thereafter at five yearly intervals.

Conclusion

Walter's consistent outperformance of the benchmark, together with the demonstrably stable discount (currently c.10%), makes RCM Technology an interesting specialist vehicle for investors looking for growth. The team have considerable expertise and experience, and the portfolio remains highly differentiated from the benchmark and peers.