Why we like software

The UK may not have iconic household names, but as the recent bid for Autonomy showed, there are highly valuable, world-leading businesses in the technology sector

Investment update

1 August 2011

Daniel Nickols, Head of the Old Mutual UK Mid & Small Cap team

Daniel has been the manager of the Old Mutual UK Select Smaller Companies Fund since 2004. He was appointed head of OMAM's highly successful UK Mid & Small Cap team and manager of the Old Mutual (Dublin) UK Select Smaller Companies Fund in January 2009.

Daniel was previously a smaller companies manager at Gerrard Investment Funds, which merged with OMAM in 2001. Daniel has over 13 years' investment experience of UK smaller companies. He is IIMR qualified

I remember in my early career reading a piece by a software analyst explaining why there were no 'gorillas' – large global leaders - in the UK software sector. Lacking a domestic market of any scale, he explained, UK software companies were locked in a vicious circle of not being able to establish a sufficiently large revenue base to allow them to devote the necessary spend to R&D which, in turn, left them falling behind largely North American competitors who were able to benefit from scale to extend their relative advantage.

We still don't have an indigenous Microsoft, nor an Apple, and we haven't produced a Google or Facebook, but we do now have in the UK technology sector an array of businesses that have successfully internationalised over the last decade. As the recent bid for Autonomy by Hewlett Packard demonstrated, they arguably lead their respective global niches and, consequently, looking to the future, have the resources to compete effectively in their specific markets.

From an investment perspective, the UK technology sector stands on the right side of the thematic divide on most counts: it is overwhelmingly international in terms of where it is selling and therefore is not constrained by the anaemic UK economic recovery. Labour is its single most important cost, so it is unaffected by the rising price of raw materials. The UK Technology sector relies for the most part on corporate spending, the prospects for which look far more assured than those for the consumer (or Western consumers at least). While technology, like most sectors, will display a level of cyclicality, there is undoubtedly a significant secular growth dynamic underpinning much of the sector – each cyclical peak is likely to prove significantly higher than the last.

With a degree of hindsight, it is not surprising that the software sector in the UK has outperformed since markets bottomed in the early part of 2009. While the premium to the market is now very wide (albeit still materially lower than what we saw at the time of the 'y2k' mania), I personally see that premium being at least maintained for the time being. Investors are increasingly paying up for the certainty of growth and in the 'risk on/risk off' environment in which we currently find ourselves, investors lack the confidence to rotate into cheaper stocks in out-of-favour areas.

Our key picks in the sector include Aveva, a Cambridge-based computer-aided design software company. It is a global leader in 3D design for the large-scale complex plant and machinery used in industries such as power generation and oil & gas. We also hold SDL, which automates the translation and management of content on the web, and, on the services side, Telecity, an operator of datacentres, that is riding the wave of data growth on the internet.

So, we acknowledge that the sector looks expensive compared both to the market and much of non-bubble history, but still we feel it's right to be overweight – why? The simple

Old Mutual Asset Managers (UK) Limited
2 Lambeth Hill
London, EC4P 4WR, UK

www.omam.co.uk
+44 (0)20 7332 7500

OLD MUTUAL ASSET MANAGERS

Please see important information on last page

answer is that on a stock-by-stock basis, it is possible to identify companies whose growth opportunity appears to last well into the medium – and probably long term, and where explicit market forecasts look well supported.

Old Mutual Asset Managers (UK) Limited
2 Lambeth Hill
London, EC4P 4WR, UK

www.omam.co.uk
+44 (0)20 7332 7500

OLD MUTUAL
ASSET MANAGERS

Important information: Past performance is no guarantee of future results. The value of an investment and the income from it can fall as well as rise and investors may not get back the amount originally invested. OMAM has no house market view and opinions expressed are the views of individual fund manager(s) as at the time of writing. These views may no longer be current and may have already been acted upon. Any underlying research or analysis has been procured by OMAM for its own purposes and may have been acted on by OMAM or an associate for its or their own purposes. OMAM is the appointed investment adviser for Old Mutual Fund Manager's in-house OEIC funds. Old Mutual Asset Managers is the trading name of Old Mutual Asset Managers (UK) Limited and Old Mutual Fund Managers Limited. Old Mutual Fund Managers Limited, 2 Lambeth Hill, London EC4V 4AD. Authorised and regulated by the Financial Services Authority. A member of the IMA. Old Mutual Asset Managers (UK) Limited, 2 Lambeth Hill, London EC4P 4WR. Authorised and regulated by the Financial Services Authority. Telephone calls may be recorded for security purposes and to improve customer service. U5936/07/11