PIER 88 INVESTMENT PARTNERS

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Dear Investors & Friends,

Much has been written in the media describing the strong momentum behind mega cap technology stocks. In this paper, we dissect some of the contributors underlying this momentum, while also suggesting there may be better long-term risk/reward opportunities in other areas of technology.

We attribute much of the performance for these names to strong fundamentals, asset flows, and momentum. Year-to-date, technology ETFs have seen incremental asset flows of over $7bn with the top 10 largest ETFs representing almost $55bn in AUM.[1] We posit that the performance has attracted asset flows, which has created incremental demand for the underlying ETF holdings and subsequently added to performance. This becomes a positive feedback loop wherein good performance attracts assets leading to better performance.

An examination of the top 10 largest technology ETFs shows a strong bias for mega cap technology stocks with the majority having significant percentage positioned in GOOG(L), APPL, FB, and MSFT.

Ticker	Total Fund Assets ($bn)	Google	Apple	Facebook	Microsoft
XLK	19.4	10.54	15.04	7.17	11.00
VGT	16.5	9.95	14.03	6.78	9.71
FDN	5.2	10.15	-	8.32	-
IYW	4.1	12.11	17.29	8.24	12.65
QTEC	2.2	3.10	3.00	2.90	3.12
FXL	1.6	0.40	0.43	1.28	0.43
RYT	1.5	1.49	1.45	1.40	1.52
QLD	1.5	9.26	12.28	5.86	8.98
IGM	1.3	8.51	8.24	6.59	8.77
SOXX	1.3	-	-	-	-

Source: Bloomberg as of 11/15/17

These four mega cap stocks are also popular for other passive index funds and ETFs. The table below illustrates the number of ETFs and mutual funds that have a 5% or greater positions in the following companies:

Ticker	Quantity
MSFT	284
AAPL	442
FB	246
GOOG	182

Source: Bloomberg 11/27/2017

[1] Bloomberg as of 11/15/17

Money flows into passive funds create demand for the underlying holdings. Moreover, it is also interesting to examine the commonality of the shareholder base of these 4 stocks as they share the same 6 large institutional investors as top 10 holders.

Facebook	Apple	Microsoft	Google
Vanguard Group	Vanguard Group	Vanguard Group	Vanguard Group
BlackRock	BlackRock	BlackRock	BlackRock
FMR LLC	State Street Corp	Capital Group Companies	FMR LLC
State Street Corp	FMR LLC	State Street Corp	Capital Group Companies
T Rowe Price Group	Berkshire Hathaway	T Rowe Price Group	State Street Corp
Capital Group Companies	T Rowe Price Group	FMR LLC	T Rowe Price Group
Northern Trust Corporation	Capital Group Companies	Wellington Management Companies	JP Morgan Chase & Co

Source: Bloomberg 11/15/2017

In our view, there is an inherent risk when both active and passive money managers are investing in the same finite names. The active managers have clearly benefited from the passive flows as the stocks have appreciated, but will face headwinds if the passive funds see outflows.

Given that many technology stocks have performed well over the last 12 months, it is reasonable to ask what drove the performance and whether the trend will continue. From a fundamental perspective, the industry is very healthy and has delivered strong operating results. An analysis of the top 25 largest technology firms by market cap shows a solid business environment with combined trailing 12-month revenue of $872bn, operating income of $201bn and cash flow from operations of $246bn. Further, these top 25 tech companies have an aggregate cash balance of $509bn on their balance sheets.[2]

The market has rewarded these solid fundamentals and, in particular, these 4 mega caps have added approximately $800bn in incremental market cap this year.[3] We believe the increase in market cap and abundance of cash will lead to more M&A activity as management teams take advantage of their strong currencies. Rather than postulate whether the next 25% move for these 4 mega cap technology stocks is up or down, our research suggests that there may be better risk reward in smaller cap names which have underperformed on a relative basis. Year to date, the Power Shares S&P Small Cap Information Tech ETF (PSCT) has returned 10.82%, while the large cap Vanguard Information Technology ETF (VGT) has

[2] Bloomberg as of 11/15/17
[3] Bloomberg as of 11/15/17

returned 36.5%.[4] The weighted average price/share for PSCT is 1.38x versus 3.77x for the VGT, implying that smaller cap technology may offer a better risk reward on a relative basis.

The Pier 88 Investment Team likes to focus on smaller, off the radar names which have likely not yet garnered attention from both active and passive money managers. For example, almost one third of the technology companies who went public on North American exchanges since 2008 are trading below the initial IPO price as some of these companies were priced too high for the IPO and likely failed to live up to expectations.

Number of IPOS	217
Trading Below Deal Price	62
Below Deal Price	29%

Source: Bloomberg 1/1/2008-10/31/2017

Although it may be somewhat counter-intuitive, our experience suggests that many investors avoid companies which trade below IPO prices on the theory that the poor stock performance is an indication that the company is not a good investment. Our research informs us that the pace of innovation, particularly at smaller companies, is not always correlated with share price. In fact, investments for innovative products and go-to-market activities to drive long-term success often weigh on short term operating results and share price. Companies that break IPO price or trade below a certain market cap threshold become “un-investable” for some investors. However, our perspective is that here may be a few diamonds in the rough with good intellectual property. Our boots-on-the ground approach attempts to take a fresh perspective on the underling industry and company fundamentals. We anticipate that corporate development teams and private equity funds will always be searching for those assets which have not shared in the mega cap technology rally. Given many investors are already invested in the mega cap technology names which have done so well these last few years, we believe there are more attractive risk/reward opportunities and multiple ways to win in smaller, off the radar technology names.

Thank you for your continued support.

Best Regards,

Frank Timons
Pier 88 Investment Partners

Important Disclosures

[4]Bloomberg as of 11/15/2017

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