Reasonable valuations, potential US rate cuts bode well for tech funds

Mitigate inherent volatility with limited exposure and a long horizon

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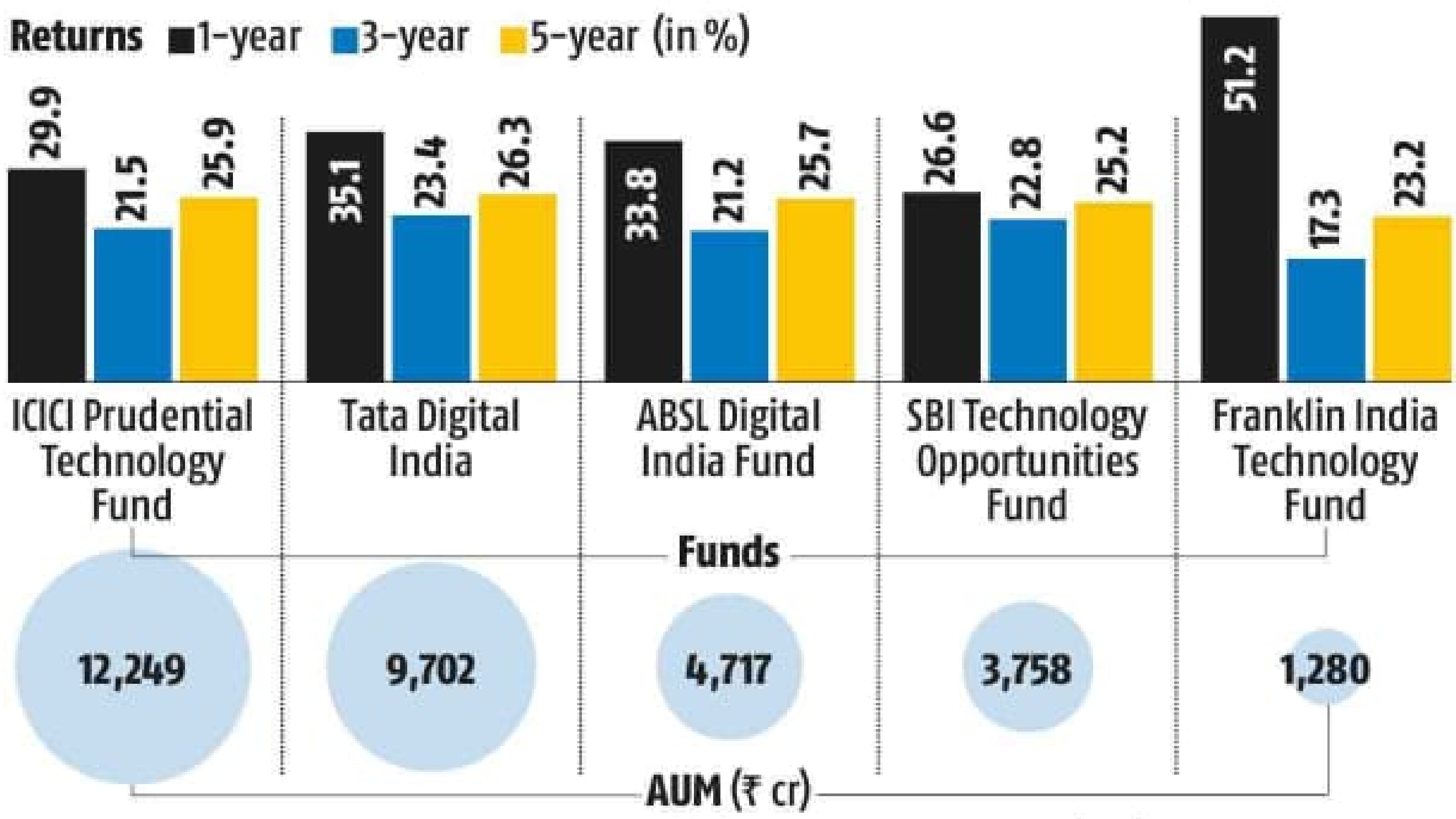
After sustaining a category average loss of 23 per cent in 2022, technology funds were up 30 per cent in 2023. Their robust performance over the past three months — they have gained 16.8 per cent on average — appears to indicate that these funds are on a comeback trail. Three new fund offers (NFOs) of tech schemes were announced recently — by Edelweiss, Kotak and Nippon India Mutual Fund.

"Considering reasonable valuations, anticipated bottoming out of earnings growth over the next four quarters, and the ongoing structural integration of technology across industries, we perceive tech funds to be a compelling thematic addition to investors' portfolios," says Trideep Bhattacharya, senior vice president & chief investment officer (CIO)-equities, Edelweiss Mutual Fund.

Mahesh Patil, CIO, Aditya Birla Sun Life Asset Management Company (AMC), too, believes tech is a good long-term bet. "The technology sector is a structural investment opportunity. Over a longer period (five-year rolling), returns from the tech sector have outpaced the broader market," he says.

RETURNS HAVE AVERAGED 35% OVER PAST YEAR



Returns are for direct plans of five largest active funds by assets under management (AUM) Source: Navigation RA

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A diverse mix

The listed Indian technology space has a wide variety of companies: software services, products, tech-enabled new-age companies, business process outsourcing, and so on.

"A tech fund should encompass not only traditional IT services stocks but also new-age tech companies leveraging technology for business advancement. Additionally, the inclusion of US technology leaders allows exposure to broader tech segments and the expanding integration of technology across diverse industries," says Bhattacharya.

Tech companies stand to benefit from the disruption caused by new-age technologies. "Investors underestimate the growth opportunities that come with artificial intelligence (AI), especially generative AI. Other sub-themes like cloud computing, fintech payments, software as a service, and the Internet of Things (IoT) provide further opportunities in India and worldwide," says Ravi Kumar TV, founder, Gaining Ground Investment.

The Indian IT sector is also known for its strong, cash-rich businesses that make regular dividend payouts and also undertake buybacks. Many are professionally managed and known for their high corporate governance standards.

Growth drivers

The interest-rate hike cycle appears to have ended. Rising interest rates were a sentiment dampener for the IT sector. This may change soon.

Rate cuts are expected to boost the deal pipeline of Indian IT companies. "With the US Federal Reserve signalling potential rate cuts in the second half of 2024, it is expected that discretionary tech spending will revive, benefiting Indian IT services. This drives our positive outlook on the sector on a one-year basis," says Patil.

Adds Bhattacharya: "The future trajectory of tech stocks will be influenced by several factors, including the growth outlook of end-clients worldwide, the movement of the rupee against the US dollar, and the inclination towards outsourcing."

Be prepared for volatility

While the future looks bright, taking exposure to a sector fund can lead to high volatility. "Tech funds entail risks such as volatility, technological obsolescence, regulatory changes, cybersecurity threats, competition, concentration risk, and susceptibility to geopolitical tensions and economic downturns," says Bhattacharya.

Patil warns that a recession in the US could impact firms within this sector.

A long-term play

Technology funds may be included in investors' satellite portfolios. Bhattacharya advises having an investment horizon of 5 to 10 years when investing in these funds.

The diversified equity funds in your portfolio will have some allocation to the tech sector. Investors must figure out how much exposure they already have to the tech sector. Innovation-themed schemes launched by fund houses may also have some overlap with technology schemes.

"Overexposure to any single sector like technology can increase portfolio risk. As a general rule, not more than 10-20 per cent of the equity portfolio should be invested in sector/thematic offerings," says Ravi Kumar.