FOUNDATION INVESTING

LONG TECH – 10/25/15

MICROSOFT, GOOGLE, FACEBOOK, AMAZON

SUMMARY

We see a "winner take all" mentality developing in the tech space, specifically in our chosen equity basket of Microsoft, Google, Facebook, and Amazon. Investors see tech as the last real bastion of growth in this fundamentally deteriorating market, especially those companies leading the cloud computing revolution. A few of these tech behemoths are establishing wide moats in this space and stand to profit for years to come as the cloud industry continues to grow with more and more companies utilizing its technology. These cloud-focused companies seem to be the last best investments for investors still looking to go long in this market. In addition to being a solid investment thesis on its own, taking these positions will help balance some of the risk we have in our IBB short. We are taking a total position of 75 BPS, spread across four different equities, with Microsoft receiving a 30 BPS allocation and the rest 15 BPS.

MSFT

Total Risk: 30 BPS	**Target 1: $62.00**
Entry Point: $52.87	**Risk Point: $48.50**

AMZN

Total Risk: 15 BPS	**Target 1: $710.00**
Entry Point: $599.00	**Risk Point: $552.52**

GOOGL

Total Risk: 15 BPS	**Target 1: $835.00**
Entry Point: $719.33	**Risk Point: $670.70**

FB

Total Risk: 15 BPS	**Target 1: $115.00**
Entry Point: $102.19	**Risk Point: $96.47**

MACRO VIEW

Our previous macro view expressed in our IBB Investment Report still stands. Valuations are stretched, we are nearing the contraction portion of the business cycle, and there is a strong likelihood of higher rates in the US before the end of the year. All of these factors contribute to a negative long-term outlook for US equities.

But even so, this does not guarantee that there's no juice left in the current bull run. The rapid recovery in equity prices from recent lows is proof of this and may reveal that the "buy the dip" mentality continues to plague the majority of investors. This coupled with expectations for more stimulus across the pond in both Europe and China have helped equity markets recover quickly.

Price action in IBB has stayed in our favor despite the recent rally, revealing biotechs to be one of the weakest areas of the market. On the other hand, we've seen a majority of recent market strength in a handful of tech stocks, including Facebook, Google, Microsoft, and Amazon. We believe this strength is a result of a "winner take all" mentality developing in the markets, where investors are piling all their funds into the few scarce areas in this market that are still providing real growth -- mainly tech. Our views are echoed by Scott Kupor, managing partner at venture-capital firm Andreessen Horowitz, who believes "...there is a huge premium [given to] large-cap player[s] [that] can actually show growth. There's just a scarcity of opportunities".

This budding "winner take all" paradigm gives us an opportunity to select a basket of strong tech stocks to play the long side of the market. This is not only a strong play in itself, but will also help hedge out any risk in our short IBB position. Still, there is some dissonance between our view of the fundamental strength of the market as a whole and the strength of this pocket of tech stocks. This dissonance gives us pause, and forces us to only retain low conviction on the macro end of this trade.

CONVICTION LEVEL: **LOW = 15 BPS**

FUNDAMENTAL VIEW

The majority of companies in our basket of tech stocks reported blowout revenue growth last week. It seems the main driver investors are now looking at is cloud computing. Marc Benioff, chief executive of Salesforce.com Inc, believes that cloud computing “is the biggest revolution in computing that we’ve seen in decades”. He thinks “we’ve hit psychological tipping point”, which seems likely as investors laser in on cloud computing numbers in evaluating these tech companies.

Amazon Web Services, Amazon’s cloud-computing arm, is now a multi-billion dollar business with an annual growth rate of 78%. Azure, Microsoft’s cloud competitor, grew more than 100% year on year in the most recent quarter. Investors see growth metrics like this and plow their money into these companies’ stocks.

These tech companies have spent billions in developing their cloud services and are now dominating that growing industry. The success from other aspects of their business has given them the cash-flows to build a large advantage in the cloud area that other upstarts will have a very difficult time matching. They continue to grow their services while taking advantage of economies of scales to reduce prices for consumers. Not only that, but they collect massive amounts of data from their customers that they use to customize and deliver even better services. Take for example the amount of data Facebook is able to collect and power that comes with using it in their personalized advertising. The years of personal data these tech companies have been able to gather gives them another advantage that newer companies once again cannot compete with. These tech companies’ moat in the industry continues to grow as they successfully build a foundation to profit off the explosion in cloud computing that will only become larger in the future.

CONVICTION LEVEL: **HIGH = 30 BPS**

TECHNICAL VIEW

Each of the stocks in this basket had a strong breakout, with some stronger than others. Microsoft in particular not only broke out of a consolidation from November of last year, but also broke through a resistance level going back to 1999, before the tech bubble crash. This pattern being the strongest, we have decided to allocate the most amount of risk capital (30 BPS) to Microsoft. It is also important to note that Facebook has not yet reported earnings and will report on November 4th. We will watch price action between now and then, and depending on profit cushion, make a decision of whether to hold through earnings or not.

CONVICTION LEVEL: **HIGH = 30 BPS**


MSFT Weekly Chart


AMZN Weekly Chart

Red Team

There is a possibility that the latest market move is a giant fake out. We know that in bear markets, volatility drastically increases, and counter-trend bull moves are always very strong and rapid, far more so than up moves in a bull market. This could very well be one of those countertrend bull moves that is setting up many investors for a bull trap. A bull trap would likely reverse the breakouts of these tech stocks and force us to stop out. Along these same lines, the latest move could be a blow-off top in equities. These breakouts could be viewed as the final thrust by the bulls before the house of cards finally collapses. This would again lead us to stop out. These are the risks we face from running with this potential “false trend” in the equity markets.