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Business

Invest in this heavily discounted technology trust but beware the growing risk of an AI bubble

ROBERT STEPHENS
QUESTOR
TRUST BARGAINS

Polar Capital Technology Trust has high-quality holdings, however backers should manage their expectations for the sector's future

According to some experts, robots are about to take over the world. Apparently, they will quickly make millions of jobs obsolete and force countless individuals to suddenly find alternative employment. Some people even think artificial intelligence (AI) will kill off mankind by taking control of its own programming.

Investors, meanwhile, are currently falling over themselves to buy any stock linked to AI. As a result, the prices of technology-focused companies, indices and investment trusts, such as this column's previous "buy" recommendation Polar Capital Technology Trust, have soared over recent months. The trust, for example, is up 28pc this year and has now generated a 94pc gain since being tipped in November 2018.

This column, however, has a relatively cynical view of AI's potential. There has been widespread discussion surrounding robots and their capacity to dominate the world for many, many years. Just as the internet was wrongly hyped as a one-off invention that would suddenly demolish business models across every industry at the turn of the century, which apparently justified sky-high valuations for companies with no track record of profits, Questor views AI as being an evolution rather than a revolution.

Certainly, robots look set to gradually become more impactful on our lives in the coming decades. They have the potential to improve productivity and efficiency to maximise corporate profits. But investors should be extremely careful about buying grossly overvalued AI-related stocks that are temporarily en vogue.

Of course, Polar Capital Technology Trust's shares are positively under hyped at present. The trust trades at a 14pc discount to net asset value (NAV) and has rarely been cheaper over the past five years.

Its discount provides investors with an opportunity to access well-known technology companies at relatively attractive prices. Indeed, the trust's major holdings include household names such as Microsoft, Apple, Nvidia and Alphabet in what is a fairly concentrated portfolio. Those four companies together account for nearly a third of the trust's net assets.

Although the company's aim is to invest in the best technology stocks irrespective of their size, its portfolio is dominated by large-cap shares. In fact, companies with market capitalisations in excess of $10bn (£7.9bn) make up 91pc of its net assets.

Unsurprisingly, US-listed stocks account for the vast majority of the trust's portfolio. About 74pc of its investments by value are US stocks, while 15pc are listed in Asia and a lowly 4pc are European listed. Just 0.1pc of net assets are UK-listed shares, which means the trust provides a significant degree of geographic diversification for British investors. Its lack of dividend payments, though, means it will only be of interest to investors seeking capital growth.

With US inflation having declined at a brisk pace over recent months to 4pc, and previous interest rate rises yet to have their full effect because of the existence of time lags, further sustained monetary policy tightening by the Federal Reserve seems unlikely. In fact, the US economy's forecast growth rate of just 1pc next year suggests rate cuts could be on the horizon.

A looser monetary policy would be good news for the share price prospects of US-focused technology stocks. As is the case with all technology companies, they are typically valued based on projected cash flows that extend well into the future. Lower interest rates mean a reduced discount rate is used to compute the present value of those future cash flows. As such, the sector could be a significant gainer as the current era of high inflation/tight monetary policy comes to an end.

Undoubtedly, the trust's long-term performance has been somewhat disappointing on a relative basis. Its NAV growth lags the 487pc rise of its benchmark, the Dow Jones Global Technology Index, by seven percentage points over the past 10 years. However, its large discount to net asset value and the long-term growth potential of its major holdings suggest it is likely to produce high returns over the coming years.

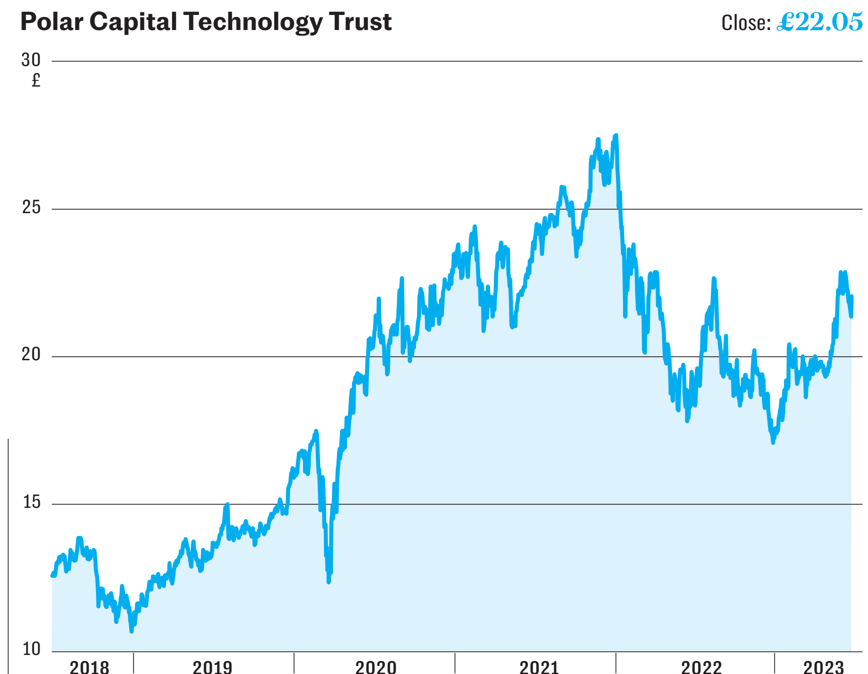
Investors, though, should not expect technology stocks to generate otherworldly returns. AI may play an increasingly far-reaching role in our lives in the long run, but it also has the potential to become a bubble that bursts.

Questor says: buy
Ticker: PCT
Share price at close: £22.05

Polar Capital Technology Trust

BUY

The trust is up 28pc this year and has generated a 94pc gain since being tipped in 2018



Key numbers

- Market value: £2.7bn
- Year of listing: 1996
- Discount: 14pc
- Avg discount over past year: 12pc
- Yield (April 2022): 0pc
- Most recent year's dividend: 0p
- Gearing: 0pc
- Annual charge (April 2022): 0.84pc

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