

Successful innovation investing

Investable opportunities sparked by innovation extends far beyond technology and can be about applying an existing technology, to develop new business models, reach new customers or address new markets

Roundtable panellists:

- **Michael Masdea**
Head of Investment Science and Portfolio Manager, Wellington Management
- **Dharmo Soejanto**
Head of Investment Partnerships & Solutions, UOB Asset Management
- **Donald Rice**
Head of Funds Specialists Asia, Julius Baer

Moderator: Genevieve Cua, Wealth Editor, The Business Times

INNOVATION is most often associated with technology. Yet the investable opportunities sparked by innovation extends far beyond technology alone. Our panel of experts share insights on how they define innovation, on coping with volatility in the tech and innovation space and their picks of megatrends that are expected to drive long-term returns.

Question: Investing in innovation can be rewarding. How do you define and approach innovation, and how do you identify truly disruptive opportunities?

Michael Masdea: Our definition of innovation is very broad – it can be a technology, a piece of intellectual property, a business model or a unique asset, among numerous other features. It can also happen across sectors, geographies and market caps – from an established large-cap company transforming its business to a new small-cap firm disrupting an industry.

Truly innovative companies control their own destiny by creating a new industry or meaningfully altering the playing field in an existing industry, driving revenue and profit growth that are not tied to economic cycles.

We compare companies across industries using our proprietary Trend, Innovation, Barriers, Risks and Sustainability & ESG Framework to try to find value. Our emphasis is on a range of innovative companies across industries, geographies and market caps. This means we are not wedded to the macro environment or short-term hype, but instead to the long-term structural trends driving innovation. Because our universe is unconstrained and focused solely on sustainable growth opportunities regardless of industry, this gives us flexibility and also a potential structural advantage in finding unique growth in a world where growth is actually pretty scarce.

Dharmo Soejanto: Many people think innovation is coming up with new technology. Actually innovation is often more about applying an existing technology to develop new business models, reach new customers or address new markets. Sometimes, it combines a new technology with an old one to come up with a compelling proposition – for example, by combining a shopping channel on TV and e-commerce to create livestream commerce with a one-click purchase. The various pieces of solution gradually develop until somebody pulls them together to make it work.

So one doesn't need to be the first to come up with a technology to be innovative. Apple, for instance, wasn't the first to create the MP3 player or the smartphone. But one may envision new ways to use technology to address new markets – one that may not even exist previously – and execute it well.

To identify truly disruptive opportunities, you need to ask, 'Who would suffer?' – that is, who would be at the losing end if the idea prevails? And sometimes, the answer may not be very obvious. For example, the electric vehicle (EV) is not disrupting the auto industry. Any car company CEO worth his salt should have an EV or clean vehicle roadmap and plans to convert production lines to cater for that. Where EV is truly disrupting is in the oil industry. If EV is truly prevalent, then the world would need significantly less petrol, which makes up the major part of output of the oil industry.

Similarly, the video conference call is not disrupting voice calls, it is disrupting business travel, including air travel (Would airlines be able to fill their business class seats?) and business hotels. The bigger the potential loss of the losers, the bigger the market opportunity of the disrupter.

Q: Covid-19 is a serious health crisis, but it has also magnified and accelerated disruptive fintech. In financial services, what types of disruption could prove enduring, and how can investors take advantage of them?

Michael: Broadly, financial services face increasing disruption from several forces, including regulatory, reputational, technological and other macro factors. In particular, this crisis has forced consumers to embrace digital technology in the "new normal", driving the adoption of mobile wallets, branchless banking and "do-it-yourself" financial ser-

Highlights:

Defining innovation

- A broad stance: A technology, intellectual property, business model or unique asset

Enduring financial services disruption

- Fintech disruption still in early stage
- Take pure-play strategy

■ Asia as global fintech powerhouse

On volatility and valuations

- Focus on companies beginning to deliver growth
- Understand the industry and company. Does it have a strong moat?

■ Diversify your exposures

Megatrends to underpin innovation

- Consumer preferences, machine learning and automotive evolution
- Breakthroughs in genomics
- Circular economy opportunities



Michael Masdea



Dharmo Soejanto



Donald Rice

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IMAGE: PIXABAY

vices. However, the shift to digital is actually still in its early stages, with developments just beginning to transform the sector.

Globally, we estimate that companies with a combined market capitalisation of US\$9 trillion in the banking sector and US\$17 trillion in broader financial services are poised to be disrupted. There is a long runway of growth that is underappreciated for a group of small and mid-sized financial services, technology and data providers.

We think this secular growth story is best accessed through a pure-play strategy – an approach that focuses on companies whereby at least 80 per cent of revenues are driven by financial technology sources, which can offer more direct exposure to the disruption.

Further, a long-term mindset focused on major secular themes such as AI, machine learning, e-commerce, IoT, mobile wallets, cloud and digital payments enables investors to capitalise on the sector's multi-decade growth and thus compound returns over time.

Donald Rice: Sitting here in Asia, one cannot be immune to the onset of disruption resulting from the accelerated pace of financial technology. Asia has already overtaken the US in terms of fintech investment in 2018 and despite market gyrations and policy shifts, it is clearly positioned to be a fintech powerhouse globally. Even taking into account recent setbacks, long-run drivers include ever-increasing rates of adoption, favourable demographics and the irreversible shift towards cashless payments. All these underpin the secular trend.

Although the continually evolving nature of the financial regulator's framework may lead to some moderation in earnings growth, it may also serve to pre-emptively rein in

what has been perceived as potential systemic and financial risks. In the meantime, some investor interest may be destined for India's flourishing fintech industries.

Q: Investors often cite concerns about extreme volatility and lofty valuations in the tech and innovation space. What's your view on this and what advice would you give investors looking to invest?

Michael: The key is not to simply go after the next big tech or healthcare idea but to focus on identifying when companies are beginning to deliver growth that will justify the prices. For example, we might favour a company because we believe it can be a long-term structural winner with innovation-driven and durable growth through macroeconomic cycles, not because it has exposure to a growth factor.

This process and discipline enable us to have a much broader opportunity set, and to generally prefer the names that are least appreciated by the market, thus avoiding areas we consider overvalued and helping us to avoid market hype cycles.

Overall, there is no empirical basis to finding the right companies but there's certainly a pattern to spotting innovative companies. Coupled with active management and bottom-up research, we believe these are keys to identifying winners in the space.

Dharmo: Let's take Amazon as an example. The share price of Amazon (at about US\$3,300 a share) has appreciated almost 2,000-fold (after adjusting for stock splits) since its listing in 1997. The thing is, the appreciation has not always been a straight line. There were periods, such as the dot-com bust

in the year 2000, when the share price corrected almost 50 per cent. And many investors would likely have been tempted to take profit after seeing the share price double or triple, and they would have missed out most of the gains.

This is my advice: Understand the industry and the company. How big would the end market be, and how big a market share would the company be able to take? That would give you a sense of how much the company could be worth. You would also need to understand if the company has a strong moat – that is, how resilient is it against the risks of new competition or new technology that could change the landscape? Its moat also includes the quality of management in terms of execution and growing the company. The more closely you study and know the industry and company, the more confidence you would have to own the stock, and you would also be less swayed by price volatility.

If you are unable to do that, then diversify your risks by investing in many small positions in such companies in different sub-sectors. Then at least you would have a fair chance of owning both winners and losers. Hopefully, the gains from the former would more than offset the losses of the latter. Alternatively, you could turn to professionals and invest in actively managed unit trusts or buy ETFs that invest in such sectors. Regardless of your approach, I would advise that this exposure should not be the bulk of your portfolio given the higher risk. For most investors, I would recommend allocating not more than 10 to 20 per cent of your portfolio.

Donald: Investors could be forgiven for allowing blockbuster Q2 earnings to assuage their concerns about resurging virus variants, inflationary fears and major US indices reaching

all-time highs. But given enough hindsight, global investors may have to concede that this may be 'as good as it gets' as peak growth and peak stimulus begin to recede. As we move back to a more normal economic and policy backdrop, it may be time to slightly shift gears.

The tailwinds that benefitted value stocks have diminished and therefore one should consider reallocating into defensive growth stocks, with a preference for healthcare and information technology. With the possibility of wage inflation waiting in the wings, headwinds may be in store for labour-intensive sectors such as industrials and consumer cyclicals. Therefore, a rotation out of cyclicals as well as value, into defensives and growth should likely continue.

Q: What megatrends do you believe underpin innovation opportunities in the long run, regardless of economic cycles?

Michael: The rise in technology is arguably the most significant megatrend and is dramatically changing how we invest. But because we take a bottom-up approach, company-specific fundamentals would already offer some mitigation against the peaks and troughs of economic cycles. Accordingly, current themes that interest us include consumer preferences, machine learning and automotive evolution.

■ Since the proliferation of smartphones and social media, there has been a measurable shift in consumer preferences centred less on what you own, and more on what you do and experience. This noticeable shift in personal consumption expenditure is creating broad investment opportunities.

■ Companies are collecting and storing unprecedented amounts of data from the proliferation of digital interactions and new sensors, leading to a revolution in machine learning and AI that will impact nearly all sectors of the global economy.

■ Finally, we are on the cusp of a transformation in automobiles due to the secular drivers of a move towards electric vehicles and the widespread adoption of advanced driver assistance systems. Both trends will lead to significantly higher technology content in a standard vehicle.

Another major megatrend is climate-change adaptation. Mitigating the considerable extent and impact of climate change implies a major shift towards a low-carbon, circular economy. In the past, the market has been hyper-competitive and highly regulated, but we are seeing technology increase the barriers to entry and make the market more investable.

In a world that is undergoing massive growth and profound transformation, a contextualised, nuanced understanding of the shifts in enabling technologies, science and policy across industries and geographies is key to success in innovation investing.

Dharmo: Megatrends are social, economic and geo-political trends with long term trajectories that would shape our societies, cultures and business environment for decades to come. Some of these megatrends include:

- 1) demographic changes, such as the ageing population in developed countries and falling birthrates almost across the world;
- 2) shift in global powers; and
- 3) climate change.

These give rise to investment opportunities in areas such as healthcare (such as telemedicine and geriatric care), automation & robotics, artificial intelligence and de-carbonisation (which would include clean energy, clean transportation, green building and cities)

Donald: Events of the past year have pulled back the curtain on the vulnerabilities of mankind and the planet. As such, developments in genomics have begun to capture the attention of the market. Rapidly declining gene sequencing costs and increased computing power have led to breakthroughs in the quest to combat chronic disorders and infectious diseases. Given the ageing global population, this trend is likely to stay intact for the foreseeable future. Investors may benefit from investing in companies focused on gene-based therapeutic treatments, gene editing and gene modification activities.

The notion of a 'circular economy' is gaining increasing acceptance as tackling the world's enormous waste production and its impact on our planet have now transformed into a structural growth story. The circular economy is in contrast to the linear waste stream that simply ends up in our burgeoning landfills, as it seeks innovative solutions to the reuse of resources by favouring sustainable packaging, selective consumer goods, and waste management companies. This is a special structural growth story that should be viewed as more defensive with strong tailwinds supported by ever-increasing regulation.

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