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to Invest

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# The Internet of Things Is Transforming Industries

#### **Executive Summary**

- Today objects have connectivity, enabling them to transmit data over the Internet with no human intervention needed.
- Industrial production, as one example, can be transformed because machine parts can send messages to their original manufacturer when they are wearing down. Replacement parts can be shipped without the machine ever having to go offline.
- When investors employ investment strategies that have the flexibility to take both long and short positions, they can potentially realize gains both from the companies that are benefitting from a change reshaping an industry and from the companies that are adversely affected by it.

My investment team and I are always looking for major changes taking place in the world that can present opportunities for investors. One big, disruptive change that is reshaping the landscape for many industries is the Internet of Things (IoT), a now fashionable term that simply means everyday objects have connectivity and can send and receive data.

We all recognize how much our lives have changed from the ability to access and transport data across the Internet. And we're already long past the days when the Internet could be accessed only through computers. Smartphones, the Apple Watch and devices like Fitbits have provided Internet access on smaller and more portable devices. More and more objects will be taking advantage of what can be achieved through Internet communicationsand with no intervention required from us. We may soon, for example, have sensors in our refrigerators that recognize when we are low on milk and which would then alert automated delivery services to bring a fresh half gallon to our doorstep so that no one in the family would have to start their day with nothing but dry cereal for breakfast!

By 2020, there may be 24 billion IoT devices installed—far outstripping the number of traditional computing devices (such as smartphones, tablets, smartwatches) that access the Internet, according to a recent Business Insider Intelligence report. The same report projected that the \$6 trillion that will be invested in IoT devices over the next five years could deliver a \$13 trillion return on that investment by 2025.

## Changes that Could Rock the Industrial Sector

The implications of IoT go far beyond the consumer. IoT is already starting to have a major impact on the industrial world. The industrials Analyst on our team was recently out visiting farms because the companies he covers include firms that provide tractors, harvesters and planting, seeding and tilling equipment to farmers. He noticed there was a company providing a service that enabled farmers to rent a drone that can fly over their land and provide a report of any issues that needed to be addressed, such as an insect problem.

Not FDIC Insured May Lose Value Not Bank Guaranteed He recognized from this example that the potential of the Internet of Things extended far beyond farming. Our team recognized that while the demand for new industrial equipment is waning, the demand for servicing existing equipment is not. Having sensors on any type of industrial equipment can provide information on when its parts are wearing down and in need of replacement. The original manufacturer of the equipment can then send out a replacement part. The company relying on the equipment may never have to experience a breakdown and downtime, while they wait for a servicing company to come out and repair it. We knew this type of technological innovation could disrupt the industrial equipment, parts, and servicing and maintenance industries.

# IoT Is Empowering the Transformation of Some Companies

One company that is making a full commitment to the Internet of Things is GE. It has divested most of its financial services and commodity appliance businesses and is now more focused on its roots as an industrial company, supplying equipment for the aviation, health care, oil and gas, and locomotive industries. They've made a big investment in technology to provide smart equipment with the sensors that can take full advantage of the IoT phenomenon, and they've established an open architecture platform, called Predix, that allows software developers outside of GE to come up with evermore innovative ways to maximize the capabilities of smart equipment.

GE developed a video that demonstrates just how far-reaching this technology can be. In the example of turbines being delivered to a wind farm, the cargo ship that initially delivered the turbine parts could be equipped with devices that monitor every machine part on the ship, sending signals about its estimated travel time, and even regularly checking on the condition of the inventory being transported. Once the parts travel across train tracks to their ultimate destination, the same level of monitoring can be sustained. When the turbine is finally installed, data from the machine can be combined with historical information about wind patterns in the area to ensure every detail of the turbine's operations-including the pitch of its blades—performs at levels that optimizes the amount of energy it produces.

This example—of an old-line industrial company being able to expand its capabilities into an area of innovation being driven by technology—demonstrates that there are still opportunities for investors to pursue significant rates of return even while worldwide growth has slowed. The International Monetary Fund is forecasting that global growth for 2016 will be just 3.1%, so it is even more critical today to find those pockets of opportunity where the potential for growth is still high. We believe companies that can effectively capitalize on the promise of IoT will be able to realize gains that outpace the rate of global economic growth.

### Some Companies' Business Models Are Not in Step with the Changes

On the other side of the equation, there are some companies that will be negatively impacted by the Internet of Things. Examples include firms that provide parts and services to industries. In the past, they operated from a real position of strength because they could charge a premium price for arriving on the scene with a replacement part and the repair expertise when a customer really needed it to bring a broken machine back on line.

But now the industrial distributors have two problems. IoT will increasingly enable the original manufacturer to deliver a new part before the old one ever breaks down and Amazon—that master of logistics and distribution—has entered their business.

In the past, the stocks of these industrial distributors had high valuations because they had good pricing power and stable, not cyclical businesses. But with the erosion of both their pricing power and the demand for their services, we think these stocks will be challenged on a long-term basis.

# The Advantages of Being Able to Go Long and Short

One of the advantages of our portfolio is that we can take both long and short positions. We like to go long companies that have improving fundamentals and reasonable valuations, and short companies with deteriorating fundamentals and high valuations. That gives the portfolio the flexibility to realize gains for investors from companies positively and negatively impacted by changing environment, in multiple market conditions, including declining markets.

#### The Internet of Things in Action



With IoT, we are taking long positions in companies like GE that we think are poised to reap considerable gains from the changes this new technology brings, while we are shorting companies which we think will be adversely affected.

Valuation analysis is a critical part of the process. It is equally important to identify the companies benefitting from a change when they are relatively inexpensive and before their potential is widely recognized by the market. By obtaining these companies at a good price, one can realize greater gains as their competitive advantages become more widely recognized.

Similarly, for the companies that will be adversely affected by a disruptive change, it is better to invest in them before their problems have been widely identified and to pay particular attention to those companies whose stocks are overvalued. The short positions in these companies should benefit as their challenges and deficiencies become evident to other investors.

To borrow a metaphor from the world where our Analyst first recognized the full potential of the Internet of Things, the flexibility that long and short positions afford us, along with the discipline we bring to our valuation analysis, enables us to harvest more of the benefits that can be reaped from changes that are transforming companies, industries and economies.



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Michelle Borré serves as the sole Portfolio Manager of Oppenheimer Fundamental Alternatives Fund (QVOPX) and the lead Portfolio Manager of Oppenheimer Capital Income Fund (OPPEX). Previously, she served as a Senior Research Analyst covering special situations for the firm's Value investment team.

Prior to joining OppenheimerFunds in 2003, Michelle held various positions at J&W Seligman, including Managing Director and Partner.

Michelle received her Bachelor's degree from Barnard College, Columbia University, where she graduated Cum Laude and with Departmental Honors. She holds an M.B.A. from Columbia Business School with membership in Beta Gamma Sigma National Honor Society. At Columbia Business School, she served as an Adjunct Professor of Finance and Economics; and served on the Executive Advisory Board at The Heilbrunn Center for Graham and Dodd Investing at Columbia Business School from 2004–2005. She is also a CFA charterholder.

As of 8/31/16, GE constituted 0.99% of Oppenheimer Fundamental Alternatives Fund's assets and 0.63% of Oppenheimer Capital Income Fund's assets. Neither Fund owned Amazon. Fund holdings are dollar-weighted based on assets and are subject to change.

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