



IS IT TIME TO BUY TECHNOLOGY STOCKS AGAIN?

Investors Are Rightfully Pessimistic as Well as Cautiously Optimistic

The storm that swept the Technology sector during past year- and-a-half triggered the most precipitous falloff in Tech stocks the industry can remember. Now that the waters have calmed somewhat, it is a good time to re-visit Technology stocks. We believe the answer to the title question above is “no” but also “yes”. We will explain.

For Individual Tech Stocks—No, It is Not Safe to go Back Into the Water

In our opinion, investors should not go out on a limb with individual Tech names right now because the industry environment is still too fragile. In the near term, instead of full-blown recoveries, we will see short-term rallies in beaten up technology stocks because of changing investor psychology. Moreover, upturns will tend to fade until companies’ fundamentals improve substantially. In addition, excess manufacturing capacity may continue to squeeze profit margins. Finally, valuations may never return to the levels seen previously. These are just some of the risks associated with the Technology sector. We recommend Tech stocks only on a select basis.

In Diversified Portfolios, the Answer is Yes—Accumulate Cautiously

That said, however, we do recommend Technology stocks for managers running diversified mutual fund portfolios—where it is safer to ease back into the sector. The portfolio manager is able to track the health of his holdings, while balancing the portfolio against risk. Here, we can take a wait-and-see attitude, while still participating where we see value.

However, even fund managers with diversified portfolios should be wary of what they buy. We recommend that portfolio managers look at the Technology sector industry by industry, tracking their improvement. In the meantime, we can trust our fund managers to choose the Tech stocks with the best fundamentals in place for continued growth.

Remembrances of Things Past—The Perfect Storm, 1995-2001

The Perfect Storm—that is how one of our analysts describes the Technology collapse. What are the components of a “perfect storm”? First, we would say *an element of surprise*. To stay with the metaphor, picture yourself in a small, rickety boat. It is a warm day, with a cloudless cerulean sky; the water is calm, and all is well. Suddenly, a storm comes out of nowhere. The sky darkens and the sea becomes rocky. It is clear that the boat is about to capsize; there is no escape from its impending destruction.

Well, the Technology boom—and its bust—came upon the investment world in much the same way. The years leading to 2000 were a “Tech bubble”. We felt we could only go higher. The number of dot.com startups was unprecedented; the environment was heady; and, we were making lots of money. By the end of 2001, the Technology sector had just survived its most painful term ever. The Tech blowout was shocking and complete. It spared no company, whether an industry giant or a small player. The storm caught everyone off guard—IT gurus, manufacturers, and buyers, even the CEOs of leading Tech companies!

A second aspect of the perfect storm could be the *domino effect* that the fallout demonstrated. The various industries in the Tech sector—telecommunications, wireless, contract manufacturers, telephony, personal computing software/hardware and semiconductors—are interdependent. Once one goes, the rest follow.

Our Near-Term Strategy—Industry Themes is the Way to Go

Because the crisis affects each industry differently, our strategy is to look at Tech stocks on an industry-by-industry basis. For example, we would *overweight* Computer Hardware because of low expectations combined with reasonable valuations. We would *underweight* Communication Equipment, because we think its downturn will last longest. In addition, in Software, we recommend focusing on back-end vendors, since sales growth is still slowing in enterprise applications.

How We Choose Individual Stocks

In Technology companies, we are looking for: 1) Adequate balance-sheet strength; 2) Peaking inventory/sales ratios; 3) Easier comparisons; 4) Re-Acceleration of orders; 5) Stabilization or re-acceleration of revenue; and 6) Margin expansion.

For example, in Telecommunications Equipment, we are recommending **Cisco** instead of Sycamore because Cisco has the breadth of product line versus point solution. The company also has shown its ability to integrate acquisitions successfully. In Semiconductors, we like **Dell** over Intel because Dell has the industry’s best management. Dell also is an industry leader steadily gaining PC market share, versus a near-monopoly provider (Intel) who is ceding share. Both companies have attractive valuations relative to their peers, and they display the sound fundamentals cited above.

The Road to Recovery

Our view varies by industry. The PC industry was first to correct, thus it should be first to recover. Communications Equipment recovery could be more than a year away. The Software industry is relatively stable. Semiconductor sales should trough in the third quarter. Analog- and PC-related Semiconductors should recover first, while Wireless-related companies will suffer longer.

Market Outlook—Is the Storm Behind Us?

As we mentioned earlier, we may see short-term rallies in Tech stocks. But the uptrends will be fleeting until companies' fundamentals begin to show sizeable improvement. Excess manufacturing capacity may continue to limit profit margins in the near term. And valuations may not return to their previous levels. No one knows whether the recent demise of Technology stocks is truly over, or if it is lurking behind a cloud. Importantly, though, we still are learning from this experience.

Think of what it means to have *Technology stocks falling, Inventories increasing, and Orders diminishing*—all in one year! As fast as investors pulled their money out of Tech socks, and as fast as the stocks fell, Tech manufacturers pumped out product just as fast. This implies that manufacturers were as surprised as anyone by the crash of Tech stocks. They built product based on the sector's peak in 2000, and continued to build as if the bubble would never burst; while all around us, the high-tech spending boom collapsed. Could no one see it coming? Or, blinded by the storm, did we *choose* not to see it coming?