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As War Looms, Tech Booms

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With concerns about a war with Iraq playing havoc with blue-chips this year, investors are suddenly finding a measure of stability in technology, where world politics matter less. Whether the outperformance can continue, however, remains to be seen.

The S&P information technology index has gained more than 1% this year, beating the **S&P 500**, which has fallen 4.7%. Networking stocks have done particularly well, rising almost 13% on average while software and semiconductor stocks also have posted gains.

This relative strength is surprising to some analysts; they say highly volatile stocks are usually hit hardest when the overall market is declining.

Clams Casino

Although some of the gains in the tech sector are clearly the result of old-fashioned speculation, there have been a number of positive developments in tech land so far this year. For one thing, earnings growth has improved markedly. While S&P 500 earnings are estimated to have grown 10.4% in the fourth quarter, tech earnings are thought to have risen 22%, according to Thomson Financial/First Call.

And the pattern is similar for the first quarter, with S&P profits projected to climb 7% compared with 14% for the technology sector. What's more, the estimates for tech profits are holding steady and have even been increasing slightly over the past couple of months, while projections for the overall market have slipped, First Call says.

"Most companies have hit their numbers and some have exceeded," said George Gilbert, manager of the Northern Technology fund. "You could argue that expectations have been pulled down but at least we're on the right side now."

Gilbert said he also has been impressed with the recent improvement in revenue growth. While his data show that sales growth for the largest 20 tech companies was up just 2% in the fourth quarter, Gilbert said this shows some possible stabilization.

Tech firms "may not be growing but they're not in the death spiral any more," he said. "Things aren't getting worse, so people then jump to the conclusion that things must be getting better."

Pie Expands

Signs of life in capital spending also have given some investors reason to be optimistic. Business investment rose 1.5% in the fourth quarter after declining for two years, and spending on equipment and software jumped 5%, the third consecutive quarterly gain for this segment, according to the Commerce Department.

Furthermore, a couple of companies -- **Microsoft** (MSFT:Nasdaq - news - commentary) and **Qualcomm** (QCOM:Nasdaq - news - commentary) -- recently issued dividends, sparking hope that more technology companies will use their large cash hoards to return money to shareholders. Although the amounts paid out by Microsoft and Qualcomm are minuscule, tech firms have traditionally resisted paying dividends, making even the smallest yield somewhat notable.

And despite their high beta, Salomon Smith Barney analyst Tobias Levkovich said tech stocks are "less vulnerable to risk aversion" because of their low debt-to-capital ratios and flush bank accounts.

Independent research firm Market Profile Theorems is excited about tech for a different reason. The company, which tracks insider buying and selling, said technology insiders are "once again showing uncharacteristic bullishness about their own companies."

While the level of bullishness has not matched that of July and August 2002, the current data suggest that investors should increase their weighting in the technology space, the firm said last week.

"It is true that the technology segment, on a long-term basis, has exhibited strong growth, and there are plenty of people who feel that growth will resume, and therefore there are people willing to take risks to get on board in a period when the markets are soft," said Steve Smith, managing director at Broadview Associates.

Back to Normal

Still, some analysts worry that the tech sector may be in for a correction that brings it more in line with the broader market. Although tech earnings growth is outpacing that of the broader market, so too are valuations.

Indeed, some analysts contend that information technology is the single most overvalued S&P 500 sector, and stands near all-time highs for overvaluation relative to the rest of the S&P 500. The IT group trades at 2.29 times sales, which is higher than any other industry group in the S&P, and well above the 1.04 multiple it held in the 1991 to 1992 period, according to FactSet Research Systems.

Gilbert said while he feels price-to-forward-earnings estimates are now back in line with their historical norms, he questions whether tech stocks should trade at an even lower valuation than they have historically, given that future growth rates are likely to be lower going forward than they have been in the past.

"Growth rates will be lower historically," he said. "But then again, I'm not sure what sector of the market has a lot better growth."

Jeffrey Saut, chief investment officer at Raymond James, said owning high-beta stocks could be a winning strategy if the pundits are right and the broader market does turn around this year, but that's a risk he isn't yet ready to take.

The general thinking is that there's only a 1% probability of the market ending down this year, because stocks have fallen only four times in a row on just one occasion during the past 100 years, Saut said. "So money managers have got to own beta." Stocks with higher volatility tend to do better when the market and economy are improving.

Still, Saut believes there is, in fact, a 33% chance of the market ending lower in any given year, and he feels that investors are still overly optimistic about the prospects for technology, which could take years to recover after a three-year slump.