The Gazette

Technology stocks are cycling back into fashion

BY FRANCOIS ROCHON, THE GAZETTE MARCH 1ST, 2011

Forget resources, now is the time to reconsider tech stocks.

What a difference a decade can make. At the beginning of 2000, investors around the world were eager to own technology stocks, at any price. Cisco Systems and Nortel were trading at price to earnings ratios (P/E) of 100 times (and they were not even the most expensive stocks of that universe). Cisco Systems is now trading 75 per cent lower than 11 years ago and its P/E is a much more reasonable 13 times. As for Nortel, it's no longer with us.

Microsoft ($27), to take another example, is down 50 per cent in 11 years, although earnings have increased threefold (that's 11 per cent compounded)! How frustrating it is to own a blue chip that triples its profits and the stock is down by half. This sour experience is keeping many investors from looking at Microsoft and other tech stocks, even though it looks incredibly cheap. Microsoft has $30 billion in net cash ($3.60 for each share). You effectively pay $23.40 for a company that will earn $2.70 in 2011. So its adjusted P/E ratio is only nine times. Microsoft's fundamentals are solid: it is in the middle of a new product cycle (spearheaded by Windows 7) and has some promising future products, such as Windows Azure for cloud computing. Also, its new entertainment product, Kinect for the Xbox 360, is a huge success.

This week, HewlettPackard ($42) was down $6, or 12.5 per cent, because of management issuing a more conservative estimate for its growth in 2011. If you look more closely at HP, the company should earn approximately $5.47 per share for 2011. So the stock trades at eight times earnings. We're not talking about an unknown or weak company: HP generates $120 billion in annual revenues and is part of the prestigious Dow Jones industrial average. HP is also widely diversified: it is a leader in computer sales and IT services (with the acquisition of EDS a few years back). But its best division - by far - is the printer business. The business model of selling ink cartridges is similar to Gillette's business of selling disposable razor blades.

Historically, however, tech companies were not known for rewarding shareholders with big dividends and share buybacks. In fact, issuances of shares (through stock options) were widely used in that industry and always a source of dilution for stockholders. And buying back stock at 50 times earnings was not a wise use of capital. Companies like Google and Apple now have treasure troves of cash but they are not returning any of it to their shareholders. Microsoft, Texas Instruments and HP, on the other hand, have been more inclined to pay a dividend and buy back stock.

In fact, Texas Instruments has bought back more than 30 per cent of its shares in the last six years. Microsoft has bought back $5 billion of its own shares in the last quarter alone and HP has bought back $8 billion in the last year. These companies are finally getting the message: why make acquisitions at premium prices when you can acquire shares of your own company at a huge discount?

As usual, investors are not pursuing what is undervalued (and has done poorly in the last years) but are hungry for what has recently done well (and is no longer cheap).

You don't have to look far to realize that investors want to own anything that is linked to resources: oil, gold, metal and fertilizer stocks. These have done well in the last 10 years or so. In 2000, as everyone was chasing tech stocks, no one wanted to own resource based companies. Now it's the other way around.

As a value investor - and a contrarian - I believe that, in the years to come, people will be disappointed by resource stocks and the few investors that have purchased the dominant, solid and undervalued companies in the tech sector likely stand to be well rewarded.

François Rochon is the head of wealth-management firm Giverny Capital, which he founded in 1998.