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MARKET CALLS

Let's Play Survivor

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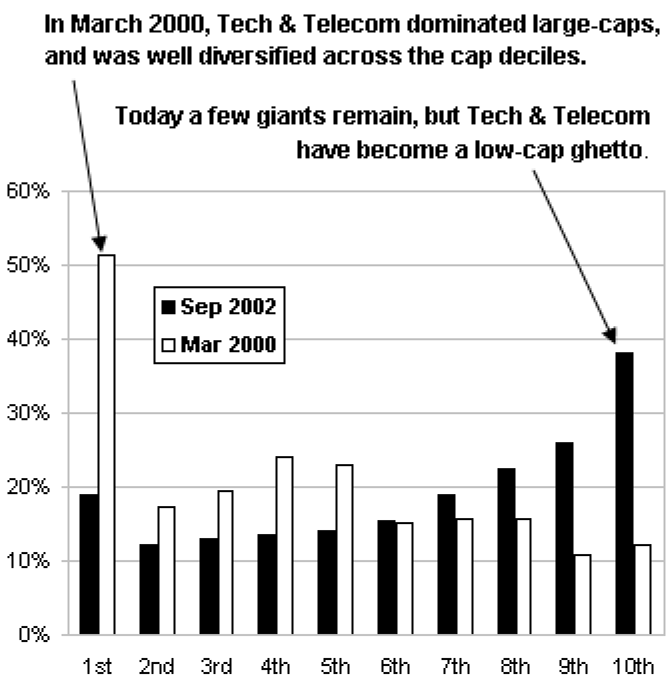
It's now a game of life and death in techland. For most portfolio managers, what counts is picking the best survivors.

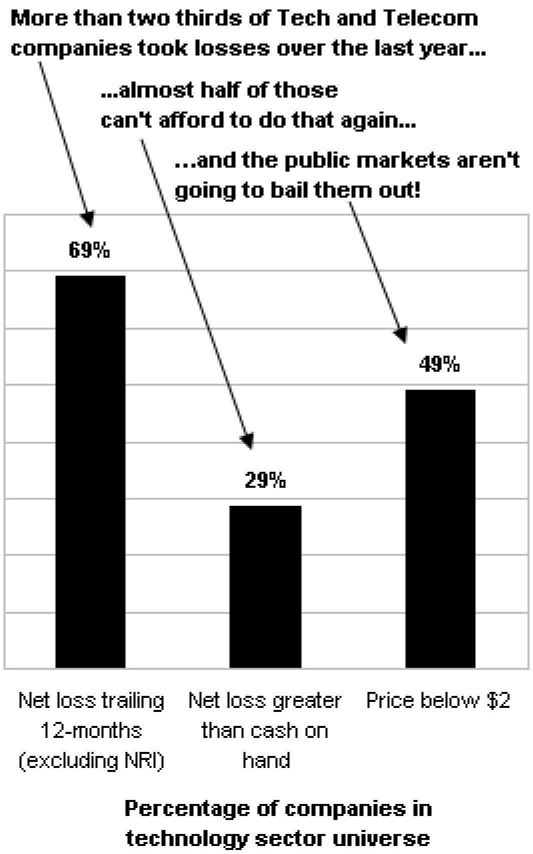
The decline since the top in March 2000 is more than just a bear market. It's a radical realignment in the basic nature of entire industrial sectors. The Information Technology and Telecom sectors have gone from being a robust and diversified universe -- populated by a mix of large-cap superstars, a broad middle class of mid-cap stalwarts, and many low-cap up-and-comers -- to what is now for the most part a low-cap ghetto.



Info Tech plus Telecom Sectors:
Representation in each capitalization decile

To quote the old song from the 1970s, *"In the ghetto, only the strong survive."* If that's true, then there are a lot of technology companies that won't survive -- because the vast majority of them are in extremely poor financial health. As the chart on the following page shows, of the 1577 tech companies for which complete data is readily available, 69% showed a net operating loss over the last 12 months (even excluding supposedly non-recurring items). Of those, almost half don't have the cash on hand to take that kind of loss again -- and that's exactly what they're facing, because the global technology economy shows no signs of turn-around. And there's little hope that the public capital markets will come to the rescue -- almost half this techstock universe is trading below $2 a share. **Alan Greenspan** may protest that he didn't dare try to "burst the bubble" of the late 1990's for fear of damaging the economy -- but this devastation of America's most critical growth sector is evidence that he did exactly that.

An atypically hopeful article in the normally bearish *Barron's* this week tried to highlight a silver lining -- it published a list of technology companies with market caps lower than the value of cash on hand. Such lists have been trotted out by tech die-hards many times over the last two years, and they've never been anything but bull traps. In our view the market is saying that the strategic prospects for these companies are so poor that they aren't even worth their cash.



We remain short the NASDAQ in our Model Positions. That said, we have written several times over the last year that the smartest technology sector strategy -- for those who want to own it at all -- would be to bet on large, financially stable firms that are number one or number two in their fields. We've argued that they could ameliorate their losses during a tech recession by stealing market share from weaker rivals, and come into the inevitable recovery with renewed pricing power, improved margins, and robust growth potential. But now that strategy takes on new meaning, and is more powerful than ever. The competition for such firms may not just be weakened in a tech *recession*, but outright destroyed in what is now surely a tech *depression*.

The logic of this strategy rules out "safe harbor" techstocks **Microsoft**, and **Intel**. These companies have no meaningful market share left to gain -- and effectively no competition, the elimination of which would improve their pricing power. In recovery, their growth prospects will simply track the technology economy.

Cisco Systems*, on the other hand, is an example of a perfect fit for the strategy. Cisco recovered from a steep revenue slide in the last reported quarter thanks to market share gains -- its competitors' revenues continue to fall. Cisco's gains are so impressive in relation to its competitors such as **Juniper Networks** and **Extreme Networks** that, at this point, it is nearly single-handedly keeping the communications integrated circuits business alive (see "Lifeline Cisco" August 7, 2002).

Cisco achieved these market share gains without significant cost-cutting, competing against putatively more advanced equipment offered at lower prices by demonstrating superior customer service capabilities and financial strength. With competitors laying off personnel *en masse*, running out of cash and having no access to capital markets, what customer would take the service risk of buying networking equipment from anyone but Cisco, even for significant price concessions? When the technology economy finally recovers, Cisco will emerge with enhanced economies of scale, deeper customer relationships, and fewer competitors -- that all adds up to pricing power and margins.

Yes, we admit it's almost intolerably dull to talk about Cisco and other establishment techstocks like Cisco. It was already dull to talk about them in 1999 -- because then it was more fun to talk about all their red-hot competitors (who are going out of business now). But let's face the facts: technology investment ceased to be fun quite some time ago. For most managers running diversified portfolios who have to own technology stocks, it just doesn't make business sense to stray outside the small circle of survivors -- the game now is really just a matter of picking the best of them.

To look beyond the survivors is to play vulture capitalist with small tech companies on the brink of death, and for most portfolio managers the risk of doing that is out of all proportion to the potential rewards. When just thirty stocks explain more than two thirds of the market value of the entire tech universe, a bet on a single company outside the group of surviving giants would have to represent many multiples of the company's market weight to have significant upside impact on portfolio results versus market benchmarks. There's a kind of manager for whom such risk represents a career-defining opportunity. But for most portfolio managers, taking that risk is a career-limiting move in an environment in which such companies, as a class, may well be headed to oblivion. TM

*The author, a principal of Trend Macrolytics LLC, owns shares of Cisco Systems.