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Techstocks: Recovery Play and War Hedge

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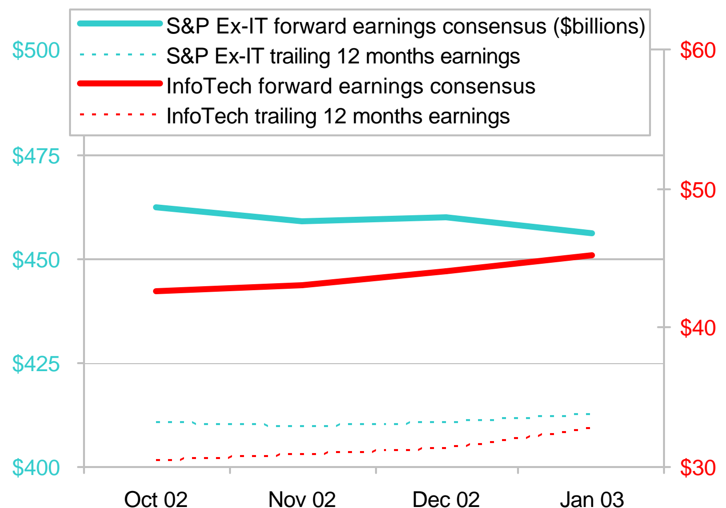
Techstocks have beaten the market this year -- thanks to both economic recovery and the risks of war.

The strong relative performance of the Information Technology sector in the face of bad news and an overall market decline is giving credence to our view that "in this time of great risk, the sector that is normally the riskiest may be among the most resilient" (see "Beyond Iraq" January 27, 2003).

- From the date those words were written, the Information Technology sector of the S&P 500 has outperformed the overall S&P 500. Through Friday the IT sector has lost only 0.4%, while the S&P has lost 1.5%.
- Year-to-date the IT sector has lost only 0.7%, while the S&P has lost 5.9%. Month-to-date the IT sector has *gained* 1.1%, while the S&P has lost 2.4%.
- Even measuring from the high-point of tech earnings expectations on January 16 when **Microsoft** issued its disappointing forward guidance and triggered a tech sell-off, the IT sector has lost only 8.9% while the S&P has lost 10.1%.

In *absolute* terms this is no bull market in tech stocks. But tech's *relative* performance is outstanding -- while the conventional wisdom would lead us to expect that volatile techstocks would be hit the hardest of all during a time of overall market decline, widespread pessimism and "war jitters" -- simply on grounds of beta, if nothing else. What's going on here?



For one thing, the last tech earnings season was not as disappointing as the media headlines would have us believe. It was *not* just another busted flush for the tech sector. The last three months saw a substantial recovery in IT sector trailing 12-month earnings from the double-dip trough they completed last October (earnings for the rest of the S&P 500 troughed in December 2001). Consensus forward earnings expectations for the Information Technology sector have continued to grow throughout the last three months -- at the same time as expectations for the rest of the S&P 500 have *declined*.

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What is the consensus seeing -- when the convention wisdom had it that this earnings season's forward guidance was "lackluster" or "luke warm"? Perhaps it's the fact that most guidance has not been actually lower or below consensus. Rather, as I pointed out several weeks ago, all that has happened is CEOs "have not been willing to forecast 'more better' results" at a time when investors were hoping to see guidance raised to build on the last quarter's surprisingly good EPS performance (see "Luskin *Live!* on Cisco and Tech's Earnings Season" February 5, 2003). And, indeed, why should they? My colleague **David Gitlitz** has pointed out that "...downbeat guidance is now seen as the prudent thing to do. Of course, it's understandable that in this post-**Enron**, post-**WorldCom**, post-**Sarbanes-Oxley** world, guarding against undue optimism is considered politically correct executive behavior" (see "Upside Downside" January 23, 2003).

And the consensus is certainly taking note of the signs that tech spending across the economy is visibly recovering (see "The Brightening Capex Outlook" February 11, 2003 and "Gitlitz *Live!* on Industrial Production and Oil Prices" February 14, 2003). And unless we imagine that the market has literally assigned a probability of zero to the enactment of **President Bush's** tax-cut plans, the prospect of pro-growth tax relief should be playing into the valuation of companies in the most growth-sensitive sector of the economy.

There may well be an entirely separate factor at work here, too, at least at the margin. While this may be counterintuitive at first, I will argue that techstock valuations may be benefiting from the fact that they may be *less risky* to hold in anticipation of chaotic disruptions arising from war or future terrorist attacks.

It's a matter of "money at risk." In a normal framework of investment analysis, an investor would regard a $1 position in high-beta technology stocks as having the same risk as, say, a $1.50 position in low-beta non-tech stocks. But these positions are only risk-equivalent in a theoretical mean/variance framework of continuous markets and normally distributed returns. With the prospect of potential market discontinuities, to some extent that framework has to be adjusted by the simple reality that $1.50 at risk in the market is 50% more than $1.00 at risk in the market. At the limit, if the whole market goes to zero, you'll lose less if you have $1.00 in **Cisco** than if you have $1.50 in **Coca Cola** -- even though Cisco is "riskier."

I admit that this analysis has a troubling *reductio ad absurdum* quality about it. But without it, it is difficult to create a *fully* satisfying explanation for the remarkably robust relative performance of the Information Technology sector at a time when, intuitively, one would expect that the most risky stocks would perform the worst. All the more so, given that Information Technology is the single most overvalued S&P 500 sector, and stands near all-time highs for overvaluation relative to the S&P 500 ex-Tech.

By any or all of the explanations explored here, the relative performance of the Information Technology sector points clearly to at least one thing: the market's difficulties this year have more to do with "war jitters" than with fears of economic weakness (see "Understanding War Risk" February 12, 2003). If war uncertainties are resolved quickly, that will leave the road clear for continued economic recovery and an improvement in investor confidence. When that happens, techstocks will lose their value as war hedges, and will face what may be significant relative valuation hurdles. But at the same time, that should set the stage for the continued recovery of the technology sector -- *that* prospect probably forms the core explanation for tech's excellent performance in this year's "pre-war period," and could do the same in its "post-war period." TM