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Putting Your Money Where Your Mouth Is: Warming up to the Tech Sector

There's an unspoken rule when trying to glean useful information from investment practitioners -- don't look at what they say or even what they write – **look at what they actually do, in real time, with their own money**. We call that "putting your money where your mouth is" and we think it's the best way to ascertain what people *really* think. Here at Riverfront, "putting our money where our mouth is" is one of the cornerstones to our "asset manager with glass walls" philosophy.

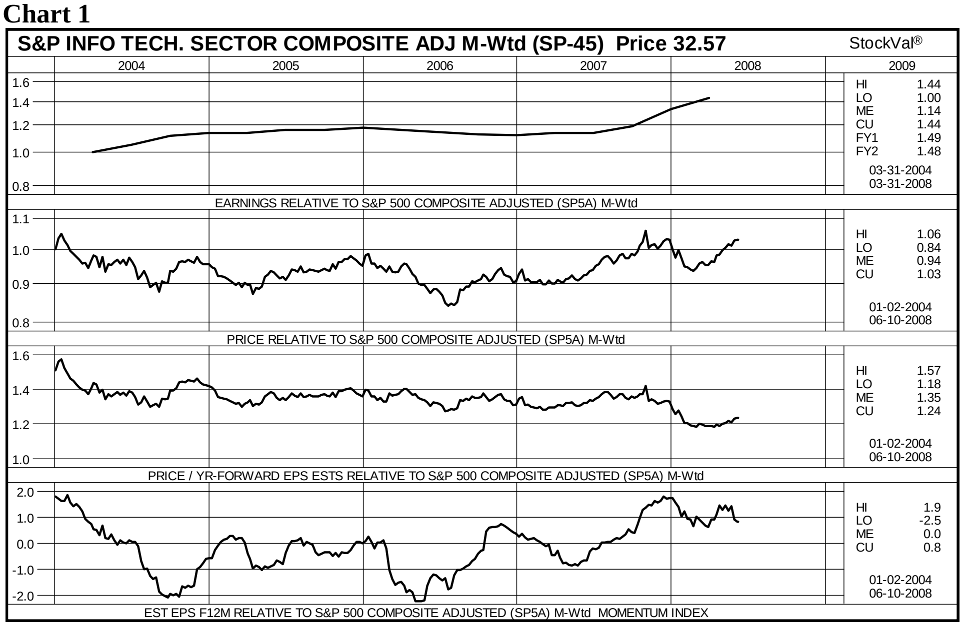
How does this relate to the tech sector? Recently, we added to our tech exposure in our exchange-traded fund (ETF) portfolios, bringing our exposure from a slight underweight to a slight overweight. This move was precipitated by a convergence of both positive fundamental and technical indicators, and in the weeks and months to come, we'll likely be looking for opportunities to go further overweight. So what are we really saying here by increasing tech? Let's try to put a framework around the reasons for our decision.

Tech: The Sector No One Really Wants to Own…
Many market participants think of tech as simply a short-term volatility trade, with no buy-and-hold qualities. We can't blame them. After all, the sector in the long run (30 years+) has indeed been a net destroyer of value, and for the last 4+ years has not really added any consistent alpha (risk-adjusted excess return) for holders. Add in lingering dark memories of net worth evaporation after the Tech Bubble burst in 2000, and you have a much-maligned space that most people generally avoid. This is evidenced by the significant fund outflows that tech has witnessed since 2000. According to Ned Davis Research, total ETF and other technology assets as a percentage of total domestic sector assets is now under 14%, a low not seen since the mid-1990s and far from the 20-year average of 22.6%.

…But, There's An Evolution Under the Surface…
However, a funny thing has happened since 2000. In true Darwinian fashion, the companies that survived the massacre emerged stronger. Today's tech companies are much leaner, meaner and more disciplined than their ancestors. All of this weight-watching has had very beneficial results: today's tech companies are cash-rich and have very little debt, which is a good way to be positioned when access to debt capital in the marketplace is tight and threatening to get tighter.

Tech companies have also grown very profitable from their discipline. For instance, tech earnings per share since the beginning of 2004 has grown by over 40% more than the S&P 500's earnings. However, since this time, tech has barely outperformed the market. (See Chart 1, top two panels). Past performance is no guarantee of future results.

Chart 1



Source: StockVal

…And It Finally Appears to be Reasonably Priced

How is that lack of significant outperformance possible? During this time, tech has also undergone massive valuation multiple contraction (see Chart 1, third panel, above). From 2004 on, tech's forward price/earnings (P/E) multiple relative to the S&P 500 contracted from more than a 55% premium to the market to just under a 25% premium.

The takeaway here is that tech now trades at a much more reasonable premium to the market -- a premium spread likely justified by its greater historical and future expected growth of earnings. Speaking of future earnings growth, we'd also note that tech earnings revisions relative to the market have been on a general uptrend since mid-2006 (see Chart 1, bottom panel), often times a harbinger of strengthening fundamentals and possible outperformance, in our opinion.

So, Why Aren't We More Overweight in Tech?

While all of the above fundamental conditions give us a generally favorable bias towards tech and keep us on the watch for opportunities to increase our tech weightings, there are also timing and value components to our investment philosophy. A number of tactical considerations are keeping us from more significantly overweighting tech at this time:

- *Economic Environment:* Befitting its cyclical nature, tech has historically struggled in weak economic environments and in times of decreasing business confidence.
- *Recent Performance Stretched to Upside?:* Tech may need to pull back off of 10%+ relative run off the March market lows.

What Will it Take For Us to Go More Overweight in Tech?

Given our positive fundamental bias, we expect that the next relative pullback in tech should be a buying opportunity, particularly if that pullback appears to us from a technical perspective to be simply a correction in a new relative uptrend. We will also be closely monitoring relative earnings revisions, relative valuations, relative strength in down market days, and top-down economic health looking for parameters that would signal potential tech additions.

Where to Position in Tech?

- **Larger-cap**: While a number of large-cap tech names continue to drag here, relative strength trends for large-cap tech compared to the rest of tech have remained generally positive since mid-2006, a slow but steady reversal from the dominance of small and mid-cap tech from 2002-2006. We also believe that larger cap tech tends to have more reasonable valuations, more global diversity of end markets, and higher levels of return on capital and subsequent economic value creation, a rare commodity in the tech space in general.
- **Software/services:** In general, we often tend to favor higher margin, higher return, less commoditized business models that have more sturdy barriers to entry; in tech's case, this means the enterprise software space and parts of data processing. Software has the highest return on capital of any of the major tech sub-industries. Processing stocks tend to have more visible cash flow due to a high level of recurring contracts. Some tech companies, such as IBM have a mixture of both as product offerings, a combination we find powerful.

Preferred Ways to Play Tech

- Apple Inc (AAPL-O-$185.64)
- IBM (IBM-N-$125.94)
- Cisco Systems (CSCO-O-$26.36)
- Texas Instruments (TXN-N-$30.42)
- Citrix Systems (CTXS-O-$33.80)
- FactSet Data Systems (FDS-N-$62.94)
- Fiserv (FISV-O-$49.61)
- Amdocs (DOX-N-$31.46)
- iShares S&P GSTI Software Index Fund ETF (IGV-A-$49.97)
- Vanguard Information Technology Index ETF (VGT-A-$56.52)

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