

Cavelti

Perspectives

Lessons from the tech crash



As most of you know, I spend part of every winter in Colorado. It was a year ago at this time that I made it a point to listen to people riding the chair up the mountain. When people ski, they're generally relaxed and glad to be outdoors. Which means they're talkative.

I was fascinated by how many people talked about stocks, then—technology stocks, to be specific. The market's stellar rise, they predicted, would not end any time soon. Not only were we in the midst of a technological revolution, but demographics would support stock purchases for years and years to come. Weren't we incredibly blessed to have been born into such a wonderful age! Almost everyone was exuberant—irrationally exuberant, as Federal Reserve Chairman **Alan Greenspan** termed it.

Every now and then I asked one of these enthusiasts what they did for a living. Apart from the local crop of ski instructors and patrollers, they represented a crosscut of the American population. One owned a bakery, another was an engineer; remarkably many worked in legal offices. Hardly ever did I come across someone who'd actually spent a week inside an investment business or a trading room. I suppose the professionals were all far too busy selling stocks to be skiing.

Everyone an expert

I remember telling my wife, Carol, how remarkable it was that everyone out there had a view on the stock market. It seemed the equivalent of a surgeon commenting on the latest brick-laying technique or a carpenter explaining the finer points of gene splicing. But even more bizarre was the general behavior within the financial community. Each time I turned on the TV, there was another broker predicting endless prosperity and new highs for all indices.

Herd-like conduct is one of the hallmarks of "the street", so I shrugged most of it off, until the week when I received predictions from no less than four establishment firms (three American, one Canadian) predicting that the Nasdaq would soon trade higher than the Dow. The old economy was dead; the new economy would eclipse it. You may remember me commenting on this absurdity. That was when I recommended an immediate reduction to zero in technology holdings.

Things have changed since. The capitulation phase that needs to follow every bubble is now well underway. Collapsing earnings and contracting multiples are pushing the technology sector to lower levels almost every day and this, in turn, forces additional selling. The Nasdaq now trades at roughly a fifth of the Dow. And the brokerage community is so shaken up that it now foresees an adjustment period of many months in which the tech wreck will continue to unwind and stocks will fall to even lower levels. Most remarkably, there is a growing chorus holding Chairman Greenspan responsible for the whole mess. Remember, this is the man who cautioned about irrational exuberance and warned the markets time after time. Oh well, I guess implicating the innocent is the final event in almost any drama.

What now?

One thing that fascinates me (even though I expected it) is just how negative the analysts have become. It almost makes me want to go out there and buy technology stocks aggressively. But I don't think the time is right for that. Consumers are still badly shaken up, partly because they're taking such a hit in the market, and corporations are feeling the weight of sagging sales. Aggressive expense cutbacks are being administered by most companies; staff layoffs by some.

So what should be done? Let me first state a very basic point: technology is here to stay. Today, the tech sector represents some 20% of broad market indices and I believe that number will grow in the years to come. There are those who bemoan the departure of the heavy industries to the developing nations. Quite frankly, I don't. I think the technological revolution has reinvigorated not only our economy, but also our lives. Many people hate the amazon.com's of this world—personally, I think they've challenged mature, unimaginative industries, made existing structures far more efficient and lent meaning to the word "user-friendly". It's always unpleasant to have changes forced upon our lives and technology has a habit of doing that. But at the end of the day we can decide to be Luddites or we can go with the flow.

Consider these three statements:

"Everything that can be invented has been invented."

Charles H. Duell, U.S. Commissioner of Patents, 1899

"Television won't be able to hold on to any market it captures after the first six months. People will soon get tired of staring at a plywood box every night."

Darryl F. Zanuck, Chairman of 20th Century Fox, 1946

"There is no reason for any individual to have a computer in their home."

Kenneth Olsen, President and founder of Digital Equipment Corporation, 1977

Many who have been disillusioned by the gut-wrenching crash in the tech sector sound just like that. "Technology is dead", is the current emotional refrain. Make no mistake--the technological revolution is far from dead and in time the tech sector will come roaring back! That a bubble stretched beyond anyone's imagination finally burst, is not a good enough reason to abandon what will probably be the fastest growing sector of the economy during the next ten years.

I believe that the analysts, too, look at the technology sector the wrong way. As they've been trained, they are looking for comparisons of what typically happens when bubbles burst and how long they take to unwind. Examples that are frequently dished up by the analytical community are the crash of the Japanese stock market and the crash of gold related assets. I don't think these are valid comparisons. The world could get by for many years shunning Japanese assets (as it very much has); similarly, investors found it easy to ignore precious metals once it became clear that inflation had been conquered. That may be the major part why the adjustment process has taken so long and why these sectors have stayed out of favor seemingly forever.

Technology, in my opinion, is very different. We depend on technology, to begin with, and the innovative process that we call the high-tech revolution has not played itself out by any means. On the contrary, it will continue to change our world in countless ways. Technology, I therefore suspect, is where growth will reemerge first and where it will be fastest, once the economy stabilizes.

Time to rebalance

So what should be done now? If you followed my advice, you had zero exposure to technology when the bubble burst. Yet, in retrospect, my first buy signal for the sector was premature. We accumulated tech stocks equivalent to 20% of overall stock exposure and, luckily, we kept total stock holdings to a very low level. As a result, your tech exposure would amount to about 9% of total assets, if they hadn't depreciated. But I've calculated that the technology portfolio I recommended has fallen by nearly a third, which will effectively have depreciated your 9% technology exposure to 6%.

Is this a good time to increase your holdings? I'm never in favor of "averaging" into a falling sector, but I've never had any difficulty rebalancing targets. If you haven't already done so, now is a good time. I suggest you now bring your technology exposure back to 20% of total equities, or 9% of your total investments.

What stocks should you hold or add? Above all things, be diversified! **Nortel's** or **Cisco's** precipitous declines illustrate how even world-class companies can experience meltdowns. In one of **RBC Dominion Securities** recent publications, analyst **Brad Willock** had this to say:

"...given the pace of innovation in technology, many argue that investors should reduce their individual company risk in the sector by doubling the number of positions." He explains how his company previously advocated four positions of 5%, which should now be increased to eight positions of 2.5%. I suspect this move has more to do with the crash of several very large technology names than with "the pace of innovation" in the industry, which is not to say that I don't agree. As a matter of fact, I've always emphasized the need for significant diversification—not only between companies, but also between the various technology sub-sectors, such as infrastructure, storage, software or networking. Because of it, there have generally been two outperformers for every bust (like **Lucent**) in my recommended portfolio.

Diversify, stick to large names

Brad Willock doesn't talk about the need to stick to top quality stocks, probably because that's what his firm does anyway. But I'll say it once again: stay away from tech's "lesser lights"--a great many of the smaller firms have already disappeared and many more are yet to come. In mega corrections like the one we're currently experiencing in the technology sector, excellence in innovation or execution aren't the only things that matter—access to capital is equally important. Financial institutions simply aren't inclined to take risks on the smaller players. The bottom line: stick to the large names—ideally those who're capable of generating profits. □

© Perspectives - All rights reserved.