

Bradley, Foster & Sargent, Inc.
Investment Management

Is The Technology Story Intact?

This is what the 1200 portfolio managers and stock analysts wanted to know at the annual Alex Brown Technology Conference held in Baltimore during the early part of October. Bradley, Foster & Sargent, Inc. was at the conference too in search of answers to some of the following key questions: Is the explosive growth of capital spending in technology likely to continue to drive the global economy or is this sector of the economy beginning to cool off? With the huge gains in the technology sector in the stock market behind us, is it still possible to make good money in technology stocks? And finally, with the technology sector of the stock market leading the stock market's performance all year long, will this hot sector continue to provide the necessary market leadership to see the Dow Jones go through 5,000 or has the stock market already peaked at 4,802 and is poised for a correction?

During the first two days of the conference, the stock market was weak with a major sell off in many of the technology stocks taking place. Some of the best known, large capitalization technology stocks such as Microsoft, Hewlett Packard and Intel were down 10% to 20% by Tuesday, the second day of the conference. Coming out of company presentations, one would see large groups of anxious money managers clustered around the monitors giving stock market quotations, while others seemed glued to the telephones calling in large sell orders. The panicked selling, significant volatility and frenzied trading in many technology stocks was definitely not conducive to a calm and reflective analysis of the industry. However, if one kept away from the stock market monitors and listened carefully to company presentations, a different picture emerged.

The portrait was one of a revolution taking place in the Information Age which is as momentous as the changes which occurred in the Industrial Age. Huge productivity increases are occurring as information is distributed rapidly through the Internet and E-Mail, telefaxes, pagers, cellular phones and satellite networks to office and home. This information is then processed by more powerful PCs at lower prices which are guided by sophisticated software. The revenues of companies in some of these technology sub-sectors are growing at 50%-100% a year.

Two of the driving forces of this technological revolution are the growing number of PCs sold annually and the huge potential of the Internet. It is estimated that the number of PCs sold annually around the world will increase from 55 million this year to 100 million by 1999. Where is this growth going to come from? Currently some forecasters predict that over two thirds of all PCs will be sold outside the U.S. Much of the demand will come from office replacement of current PCs as PCs become even more powerful, costing less, and can handle voice recognition and multi-media applications. Dovetailing with this trend is the likelihood of the geometric growth of Internet usage which currently has five million users globally. Projected rapid growth in the number of Internet users will cause the demand for telecommunication equipment including switches, routers and a host of technological applications to increase. The accelerating sales of PCs and the growth of the Internet combine to provide a powerful impetus to capital spending for dozens of sub-sectors in the area of technology.

Another part of the technology story is the increasing globalization of business. With global trade booming and capitalism taking root in formerly totalitarian and authoritarian states whose economic systems were socialist, revenues from sales and services to non-U.S. customers will continue to grow rapidly. Just as Coca Cola gets almost 80% of its operating profits from abroad, this will also occur in the technology area. Microsoft already programs its software in 19 different languages. Brazil is forecast to purchase more than 3 million PCs this year. The confluence of the technology revolution, caused by the Information Age, and the globalization of business, induced by the spread of democracy and capitalism, are two of the main forces behind the stock market's powerful advance.

We believe that these two trends will continue for a number of years, and that this investment opportunity has only been partially exploited.

The other key factors to our optimism on the stock market are a low inflation environment, moderate growth and the likelihood of a return to fiscal responsibility in the U.S. which promises a low interest rate scenario for the foreseeable future.

Does this mean that all, or even most technology stocks, are reasonably priced? It certainly does not. We believe that there are pockets of overvaluation and indeed significant speculation. Some P/E ratios are as high as 50 or 75 times 1996 earnings (America Online is a good example). On the other hand, we continue to see excellent companies whose P/E ratio is below their forecasted earnings per share growth rate.

Not surprisingly, we conclude that the technology story is intact. We also believe that the technology story will continue to power the stock market higher, albeit with periodic setbacks. A 5,000 Dow is a realistic possibility over the next six months. Finally we think it wise that every equity portfolio contain a number of top technology companies to take advantage of this excellent investment opportunity.

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