PATIENCE AND THE CRASH OF 1987

Investment theory for technology stocks.

By Clara Basile and Ellen Ullman

From April 1996 issue

The recent decline in technology stocks is a textbook example of how stock prices are a function of investor expectations. In mid-July 1995 giddiness was in the air. Portfolio managers were boasting as never before about their weightings in technology. To be heavy in tech became, momentarily, a banner of the gifted and the astute. Just six months later, in January 1996, holding even a "market weighting" in technology would not generally be a boasting matter.

Difficult as it may be, the investor must recall some of what seemed so desirable even as technology stock prices raced to their summer peaks: Investor perception swings in extremes from optimism to pessimism and back again. Perceptions will become optimistic again. The question is where and how soon.

There is good reason for today's pessimism. The period from July '95 to January '96 was an excellent time for investors whose holdings were weighted in line with the overall market. The S&P 500 rose 8.7% in just those six months, but technology investors were not happy: the PSE Technology Index declined 8%.

The sense of slaughter was strengthened by the largest and most dramatic declines coming from the technology leaders. Semiconductors, semiconductor equipment manufacturers, and wireless groups -- the secular leaders that gave technology their boastful edge -- saw the most precipitous declines. Semiconductor stocks fell 48% in just six months, and semiconductor equipment lost 56%.

In this climate, investors can't help having the feeling of wreckage. Our sentiment indicator on the technology leaders now shows a state of near coma: If 100% is death, our indicator on semiconductor equipment shows a near-death experience of 90%. Investors now hate these stocks with a vehemence. Here's the good news: when the sentiment indicator goes beyond 80%, buying opportunities are ripe for the next six months at least. The indicator shows that we've gone to the extreme of pessimism, and should be swinging back.

The last half-year has sorely tested technology investors, but technology has not necessarily lost its position as the generator of overall market secular leadership. Secular trends are made not in months, but in years. And while the seven-month picture was gloomy, investors might be surprised to discover that technology as a whole was up 48% in '95. Even semiconductors saw stock gains of 712% for the year.

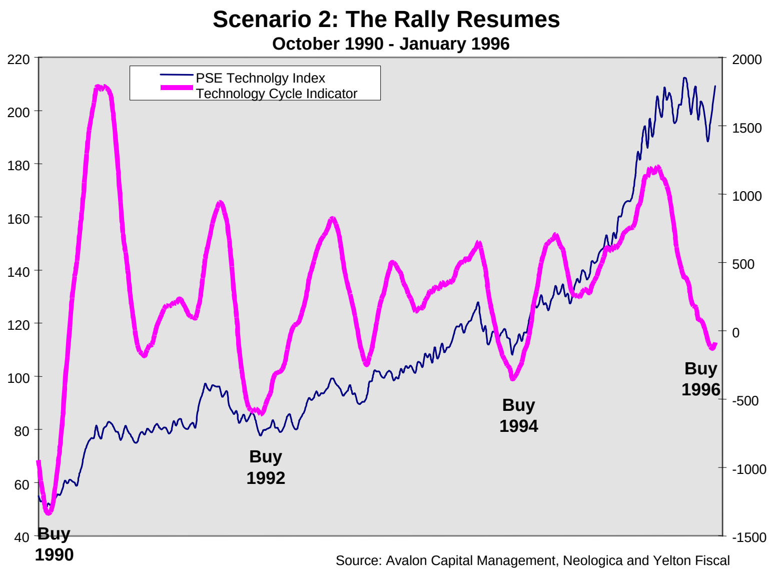
Technology will improve -- the question is what will be the shape and duration of the next movement? We foresee three possible scenarios, one of which we believe is the most likely.

Scenario 1: The burst bubble

The first possible scenario is that the bubble has burst in technology, and that (according to this way of thinking), July '95 was the final fling, the secular top in technology issues. Those giddy summer highs will not be surpassed for many years. Technology stocks will now follow a commodity-like pattern, according to this scenario, rising and falling with classic supply-demand pressures.

To support the "burst-bubble," the relative valuation of many semiconductor equipment stocks, the former market leaders, has already matched their 1984 secular peak. Technology has become "retail-ized" -- Packard Bell's bad Christmas of '95 helped fuel the recent decline. A private company did not see enough computers under Christmas trees, so down went Cirrus Logic and the seemingly invincible Intel. And the technology sector followed. It's hard to entirely ignore the seasonal, commodity pressures that now affect the technology market. Yet from 199095, investors were valuing these companies as growth stocks, instead of cyclicals.

If an investor believes in the burst bubble scenario, the proper thing is to wait for the next upcycle in the commodity pattern, then to sell. Get out completely, says this theory, or trade technology issues like other commodities, looking for the periodic dips and rises.



Scenario 2: Rally resumes

In this scenario, the setback in technology was just another steep, scary decline characteristic of secular leaders. The leaders have advanced so much that investors can't help wondering how much higher they can possibly go. Investors get more and more nervous as advances continue, money managers want to take profits, until suddenly everyone wants out. But there have been times like this before, for the secular leaders, when the leaders regained their losses quickly and moved on to new highs. Anyone who doesn't buy during this decline could be left holding head in hand.

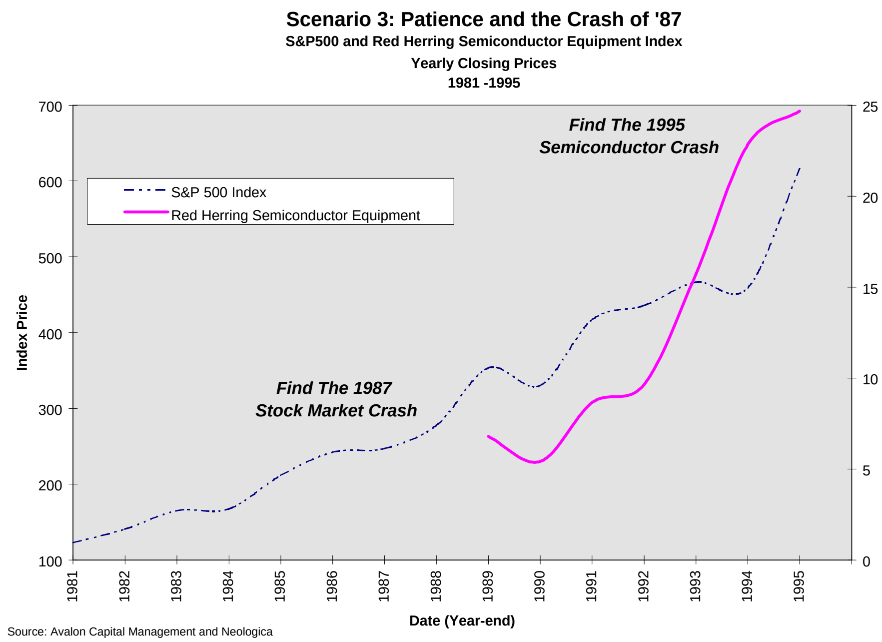
The rally might resume quickly because there has been a two-year cycle in technology. Since the '90 bottom in the secular trend, every second year has offered buying opportunities in technology issues. 1992 and '94 were good times to buy, suggesting that '96 will also be a time to buy, if the trend continues.

Then there is the rapidity with which hard-hit stocks have regained their equilibrium. Semiconductor equipment manufacturer Lam Research (LCRX) is a case in point. The stock, having peaked in July '95 at $73.38, seemed like a great value in January '96 at $42.75. Then, in one week, it dropped to $32. By January 31, the stock price had already rebounded to $42.75. If you believe the rally will resume, you would have bought at $32 and will keep buying, perhaps, in the expectation that the stock's upward march will be swift and dramatic.

Scenario 3: Patience and the crash of '87

But Lam's example is precisely what brings us to the third scenario. If you missed the buying opportunity at $32, are you likely to buy now? Most investors would probably wait for a confirmation of a new upward trend. And if you already owned the stock when it declined, you probably just sat still, not selling, but not buying yet. Again, you are waiting to be sure that the bad news is over, that a leader is indeed a leader, and all will be well again.

This waiting for confirmation of a new upswing creates a deadly embrace: Everyone is waiting for the price to go up before buying, but the price won't go up until more investors start buying. This standoff, creates our third scenario, in which technology has not lost its position as the market secular leader, but the emergence of an upward trend will unfold more slowly than investors might like.



We are most inclined towards believing our third scenario, because in the current technology situation we see many parallels to the market crash of '87. Prices rose dramatically from January to August '87, then crashed just as dramatically. Despite the perception of bloodbath and slaughter, the market was simply returning to where it started at the beginning of that year, and the overall picture for '87 was not that gloomy. If one includes dividends, investors came away from '87 with a gain of approximately 5%.

After the '87 crash, many believed the market had reached a secular peak, as many currently believe about technology. Yet the wreckage offered buying opportunities: For investors who had missed the 198287 run-up, the crash was a chance to get into the upward secular trend.

After the '87 crash, the resumption of the upward secular trend did not happen overnight. Rebuilding investor confidence took a while. Like today's Lam investor, the market waited for confirmation that advances would indeed lie ahead.

The theory of capital flow supposes that resumption of technology's secular leadership will take some time. If capital had nowhere to go except back into technology, investors would rapidly snap up languishing stocks. With the competition for that capital, investors are looking at other opportunities for growth -- whose bloody periods have receded somewhat from memory. Capital is flowing into biotech, Japan, emerging markets, gold stocks, and selective energy stocks. These areas also offer values, and their pessimistic mood swings have had time to pass. Through the end of '96, investors are likely to find their opportunities there, along with those in technology stocks. Even the traditional secular leaders, like semiconductors and semiconductor equipment, will emerge slowly.

Still, they will regain their secular leadership. Momentary pessimism does not necessarily reflect the overall investment picture. Secular trends are built over long time-spans -- which are hard to see during dramatic market falls. But the long-term trend is there. Technology, in its totality, is not the mess recent experience suggests. Neither is it the only place investors can look to for growth. It will grow, we believe, only not so fast. Patience. Take a deep breath. Buy.

Clara Basile co-founded Avalon Capital Management with partners Dave Rahn, Bruce Erickson and Bill Oberman. Avalon is a northern California investment firm that provides personalized investment portfolios for individuals.

Ellen Ullman is a software engineering and design consultant with NeoLogica of San Francisco. NeoLogica specializes in new product services for start-up and established technology companies.