THE VALUE OF STABILITY IN A DIFFICULT YEAR

The Herring's money management consulting team shows why several computer data service companies are worthy enough to be reinstated on The Herring's Tech 250 stock index.

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In December, 1993, some thirty companies were banished from *The Red Herring* technology index. To make way for information superhighway stocks, three entire industry groups -- data services, host era software, and retail/wholesale distributors -- disappeared without their companies finding a new place in the index. Like so many old buildings in the path of a new freeway, they simply had to goAs the keepers of the index (we don't pick the companies, we do the numbers), we thought we should take a last look at the banished ones. The old *Red Herring's* Tech 200 companies may seem pale beside the superhighway-charged Tech 250. But when we analyzed the charts, we found ourselves attracted to a decidedly unhip corner of the industry: computer data services.

Computer data services have been around so long it's hard to think of them as technology. Payroll services, transaction processing, and outsourcing don't exactly sit on the leading edge of engineering. So why are we looking at these old-line stocks when we could be out trying to find the hottest set-top box? The answer is steady growth and low volatility. Our research points to data services as a good defensive play in a difficult investment environment.

And we do expect that 1994 will be a difficult year. As of mid-February, the overall market is in a late-stage uptrend that is already starting to deteriorate. As we discussed in our last article, we see the last three quarters of the year as a time of transition for technology stocks. By the end of the first quarter, the average technology investor probably had made all the gains he or she was going to make for the year. Our research tells us to expect a period of hesitation and uncertainty as buyers of computer products sort out new offerings in chips, operating systems, and hardware. Capital will flow in and out of individual issues, creating some drama on the level of individual stocks, while the overall movement of the sector is flat. Until the end of the year, when we expect the generation-long secular advance to resume, we don't see many broad technology themes that can offer investors solid returns.

In the face of 1994's difficult market, how is a technology investor to proceed? One possible approach we outlined last month: on corrections, buy the leaders within technology groupings. (In late December, for example, this approach would have meant buying Applied Materials, leader of the semiconductor equipment group, when it signalled an intermediate bottom at $34.00.) A second possible approach is the one we take this month: buy the steady-Eddy data services stocks and stay with them at least through the intermediate term.

When Boring Technology is Attractive

In the current climate, we are not out there looking for the mythical next Microsoft. In considering the data services group, we are looking at companies using proven, even boring technology. The work of transaction processing, for example, relies on legacy, big iron mainframes and mainstream UNIX servers. This is not a bet on emerging engineering; we're not looking for 2000% stock appreciation.

On the other hand, data services companies are not utilities. In the recent bull market, the data services group outperformed the overall technology sector. Between October 1990 and January 1994, when the PSE Technology Index advanced approximately 135%, the data service group advanced nearly 162%. Of the ten companies in the group, six outperformed the PSE Index. Even if we eliminate group high flyer First Financial (which advanced nearly 482% in the period), the data services group turns in a very respectable advance of 120%.

The respectable advance of the data services group becomes even more remarkable when we turn to the bear cycle between March 1989 and October 1990. While the PSE Technology Index fell nearly 14%, the data services group *rose* nearly 14%. That is, in the bear cycle, data services outperformed technology by a significant 28%. Only in the depth of the bear cycle (July 1990 to October 1990), did the decline hit the data services group, presenting it with a set-back of 18%. However, this decline looks much more manageable when we compare it with the 27% retreat in PSE Technology Index in the same period.

Stock Price Stability

What this shows is the durability of the data services group. In uptrends, it has performed at least as well as the technology sector. In downtrends, it has kept its value. While technology goes sideways and the overall market deteriorates, the data services group offers stable growth, low volatility, and relatively low risk.

Further evidence of the group's stability comes from our figures on stock-price volatility. We measure volatility as the percentage fluctuation in price over a period of time, in this instance, over a one-month period. For the new ***Red Herring's*** **Tech 250**, the average volatility is 21%. (All research reflects stock prices as of February 18, 1994.) However, volatility in the Tech 250 is weighted down by the telecommunication, entertainment, and publishing stocks recently added to the index. When we exclude the superhighway issues, the volatility of *The Herring's* Index is closer to 30%. For example, the peripherals group alone had a volatility of 31%.

In contrast, the average volatility for the computer data services group was a mere 10.8%. Volatility for the group ranged from 7 - 20%, excluding Policy Management Systems, whose price has been fluctuating due to corrections of accounting irregularities.

Cycle Analysis

In our cycle work, we find that the entire data services group is attractive relative to the S&P 500, as well as to other technology stocks on an intermediate basis (6- to 9-month cycle). 70% of the stocks are in uptrends; the other 30% are completing downtrends. And capital is flowing strongly into the data services group. Only the semiconductor and semiconductor equipment groups show stronger capital flows, giving data services some fairly rarefied company.

An investor might do well to purchase the entire data services group. To highlight the potential opportunities, we looked at four individual issues as representatives of the types of investment approaches we might take. Figure 1 shows our purchase candidates.

For a long-term buy (12 to 18 months), we're considering General Motors Class E (GME), which represents the EDS data services company. The stock is currently at a long-cycle bottom. From its current price of $33.25, we're looking for a target of $48.00. The cycle work is supported by more fundamental numbers: the company obtains 41% of its revenues from General Motors and should therefore benefit from the strong improvement in the automobile industry and in the economy as a whole.

Computer Sciences (CSC) is in a strongly persistent uptrend. From its current price of $37.625, we see a target of $45.00 in the 6- to 9-month time frame. Of all the companies in the data services group, CSC is the one we most regret losing from *The Red Herring*. technology index. Among its other services, the CSC provides client/server consulting, helping corporations move to newer networked and distributed systems. As such, the company is in the thick of the larger technological paradigm shift called corporate "re-engineering" and should stand to benefit.

In Policy Management Systems (PMS) we see a turnaround candidate. The company's stock was battered on problems related to accounting irregularities. However, we see evidence that the problems have already been discounted in the stock price. From the current $35.125, we're looking for a target price of $50.00 over the next 12 to 18 months. One cautionary note, however: The recent spate of hurricanes, floods, earthquakes, and other disasters has hurt the insurance industry. According to a recent *Wall Street Journal* report, Aetna Life & Casualty experienced disaster-related losses well above analyst expectations. Since PMS provides processing for the insurance industry, it could be affected adversely if insurance companies begin restricting the writing of new policies in hardest hit areas.

In our last purchase candidate, American Management Systems (AMSY), we see a possible trading opportunity. The stock may be bottoming on both an intermediate and long-term basis. The price could move to $28.00 from its current $19.00.

Business Growth and Stability

Behind the stock-price stability demonstrated by the data services group is fundamental business stability. The group has had steady operating margins, ranging from about 10% for Computer Sciences, to 20% for GME, to 25% for Automatic Data Processing. The group also shows solid average earnings growth: 22% over the last 12 months, with projected growth over the next 12 months of 17%. As Figure 2 shows, the 5-year historical earnings growth starts at 15% for ADP and Computer Sciences, and moves to about 35% for American Management.

In general, we see room for steady growth as more companies turn to outside providers for computer services that are less and less beneficial to perform in-house. As basic transaction processing becomes simply a fact of business life, more companies are likely to view transaction processing as something akin to payroll -- a lot of trouble and expense to perform yourself without an attendant business advantage. Still, only 40% of businesses currently look to data services companies for payroll processing, a figure we see growing as employment rises with the overall strengthening of the economy.

Business will increasingly "outsource" many of their computing needs, we believe. According to figures from research company Dataquest (San Jose, CA), the market for outsourcing of all services is projected to more-than double between 1992 and 1997. The largest percentage growth in outsourcing is expected to come in the network support integration category, which is expected to grow from $4.2 billion in 1992 to $11.3 billion 1997. With the demise of the all-IBM shop and the rise of networked "open" architectures, businesses will find it more difficult to connect and maintain the various elements of their distributed systems. The entire enterprise will come to rely more heavily upon the network, validating the old Sun Microsystems mantra, "The network is the computer." With networking talent difficult and expensive to hire, businesses will tend to turn to outside help in network design and management.

We should offer one additional point about data services. All the companies in this group must keep their technology close to the industry mainstream or risk losing clients over time. GME presents a case in point. The company's entrenchment in legacy systems -- mainframe computing -- could hurt it over the long haul, as clients begin to demand more modern computing solutions.

For example, an industry trade publication recently reported that EDS lost its contract with Great Britain's Royal Automobile Club due to EDS' "unfavorable client/server economics" (*Computerworld*, February 28, 1994, Page 30). Still, GME has presented a fairly predictable pattern of growth over the last 10 years. Our point here is that investors interested in time frames longer than 18 months will need to keep an eye on technology trends. Changes in mainstream computing will effect all the data services companies over extended time horizons.

The Normalization of Computing

While we're sorry to see companies banished from a technology index, we do see some rationale for removing the data services group from ***The Herring's*** **Tech 250**. The days are long gone when the mere fact of using a computer constituted high technology. The day-to-day workings of business are now so intimately involved in the computer that it's hard to separate normal operations from basic computing. Try to imagine modern banking, insurance, health services, finance, retailing, etc., without the participation of the computer. Even the smallest company cannot get by without its payroll services and its billing programs. The ability to churn out transactions is now an unglamorous but integral part of doing business.

In a sense, the banishment of the data services group is part of a larger process involving the normalization of computing technology. Data services companies represent that part of computing that has proved itself as utterly tried and true. Mainframes have moved from being "high tech" to old-fashioned; UNIX servers have moved from being leading-edge to mainstream. And, over time, surely other technology groups will follow data services -- becoming companies driven more by good management than by chips and MIPS.

Today, data services companies are beginning to resemble the client industries they serve more than the technology sector from which they emerged. GME's fortunes ride with the automobile industry, Policy Management with insurance, Fiserv with finance. This is not to say that data services companies are not affected by technology; they are still technology providers and will have to keep their services in the mainstream of computing, even as that mainstream continues to evolve. But, ultimately, data service providers represent the accelerating movement of technology out of engineering and into normal life.

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