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Tech Stocks, Finally Debugged

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Since the Federal Reserve stopped raising rates last year, the stock market has approached heights not seen since the technology frenzy of the late 1990s. Leading the latest run-up? Tech stocks. It's enough to make investors wonder if another bubble might be forming, ready to burst.

Unlikely. This time, the rally is based on fundamentals—rather than hype—with the industry finally emerging from years of punishment following the overindulgence of the 1990s. "Apparently, six-plus years was enough of a hangover," says Douglas Peta, market strategist at J .& W. Seligman & Co. If anything, the tech sector appears poised to continue outpacing the market. "We think there's more to come," says Kim Caughey, an equities analyst at Fort Pitt Capital.

The outlook appears strong for software, tech services, and PC makers as businesses finally replace aging systems. That should boost profits at software companies like Oracle and Microsoft. "The Vista party is just starting," Caughey says, referring to Microsoft's new operating system. Business orders have already been driving PC sales above expectations in recent months, leading Intel to raise its profit projections last week. New computer orders could also help Dell recover some lost market share, Caughey predicts, because of Dell's strength in selling to big companies.

Tech fortunes depend on the broader U.S. economy, of course, and a slowdown or recession could send tech stocks, typically more cyclical than others, reeling faster than the overall market. But technology companies continue to expand abroad. And if spending slows in the United States, will the rest of the world automatically follow? "This time, nobody knows for sure," Peta says.

Some tech segments, meanwhile, could particularly benefit if the Fed trims rates. Shares in software and service companies, as well as chip makers, have jumped on average more than 20 percent in the 12 months following a Fed rate cut, according to a recent report from Citigroup.

New to the equation, however: the storm swirling around the subprime credit meltdown and its impact on financial companies, among the biggest buyers of new technology. While PC makers do anticipate some hits from mortgage firms and others, nobody's canceling orders yet, Dell CEO Michael Dell told analysts earlier this month. "Broadly, it looks pretty good," he said.

Tech, in fact, has become an unlikely haven amid the credit crunch and resulting market volatility. Despite their own reputation for wide swings, technology stocks tend to hold up well when the broader market convulses, which is likely to continue for another year or more, says Tobias Levkovich, chief U.S. equity strategist at Citigroup. Large companies like Microsoft, Intel, and Google dominate the sector, and they appeal to investors looking for size. "They also have pristine balance sheets," Levkovich points out, with lots of cash and little or no debt.

Levkovich advises investors to remain "overweight" in technology companies, although just last week he suggested pulling back on hardware and equipment companies. Those shares have jumped by a third in the past year, compared with 14 percent for the S&P 500, which doesn't leave much room for an upswing, he says. Also, Levkovich senses too much interest in those companies.

Widespread enthusiasm is reason to think twice, agrees Alan Lancz, money manager and director of Alan B. Lancz & Associates. He has largely quit buying technology shares, saying investors have bid them up as high as can be justified by potential profits. But he's not selling them yet, either. Meanwhile, he says, it's getting harder to find new tech stocks to buy—leading him to contrarian picks, such as Yahoo! The online goliath missed the tech run-up, losing nearly half its market value since early 2006 while yielding ads to Google and others. But, Lancz thinks, with new management, a turnaround is possible. Or the company might be a takeover target.

There is good reason for investors to remain broadly interested in tech, says Susan Hirsch, who manages a large-cap growth fund for TIAA-CREF. Many big companies appear to have good prospects with new products, including software maker Adobe, chip maker Intel, and even Apple—despite its stock being up more than 80 percent in a year. Apple's shares are trading richly at about 30 times its projected profit next year. But when looking for growth, Hirsch says, investors should buy the innovators. And unlike the bubble days, now innovators have real products and measurable profits. "Valuations really are not up in the stratosphere," Hirsch insists. Investors can only hope it stays that way.