

SmartMoney

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2007 Could be the Year Tech Funds Return to the Top

By Rob Wherry

EARLIER THIS WEEK, in a meeting room high over Times Square, Reuters analyst Ashwani Kaul rattled off a few of his earnings estimates for 2007. For the most part, what he described was an aging bull market that was running out of steam. The growth rates for sectors like basic materials, consumer cyclicals, energy and financials were all projected to cool off over the next 12 months. But then Kaul got to technology. This industry, he said, could grow tenfold this year from the dismal 2% growth rate it experienced in 2006. If true, that jump-up would be the largest of any sector he mentioned and almost twice the rate of the broader stock market.

Not everyone shares his view. Right after the new year Goldman Sachs downgraded many of the technology sub-sectors it covers, citing less compelling valuations after an end-of-the-year run-up.

But assuming you're willing to at least think about giving the tech sector another whirl, here's the argument for a strong year. For starters, the typical technology company of today isn't the same type that caused so much buzz almost a decade ago. For the most part, these firms have healthier financial report cards, cash on their books and, more importantly, actual earnings. Some are even paying dividends and doing share buybacks. Of course, there are still some shenanigans to worry about, especially when it comes to allegations of stock option back dating. But for the most part Technology 2.0 has been giving investors reasons to forget about the late 1990s fall-out. "This time around there are stronger balance sheets and many companies are running more efficiently," says **Paul Ohanian, a vice president with financial planning firm WealthTrust-Arizona.**

There are also plenty of catalysts that could kickstart the industry. **Microsoft** (MSFT1) is poised to finally launch its long-awaited Vista operating system. There is also a general theory that companies will continue to spend cash on upgrading their computer systems. And then there is the consumer that purchases gadgets like cellphones, videogames and high-definition TVs. The trickle-down effect of that shopping spree helps all kinds of technology infrastructure firms.

Technology also tends to go in lock-step with growth stocks, a niche that has been out of favor for some time but seems to be due for a comeback. Growth stocks, defined as those that have projected earnings rates that exceed the broader market, have returned a pitiful average annual 3.3% over the last five years. Which sector was right behind it? According to Morningstar, technology funds posted a 0.8% average annual return during that same time period. But if Kaul is right, investors will pay a premium for stocks with fat earnings when everything else is stagnant. Almost every advisor and fund manager we have interviewed over the last three months has been setting up for this supposed rally. "Tech is a bellwether of growth stocks," says Lipper's Jeff Tjornehoj. "If capital spending increases or is at least maintained at its current level it could be a boon."

There are a couple of ways to play this comeback. This week's screen looked for low-cost technology mutual funds that were in the top 40% of their peer group over the last three- and five-year time periods. (One of the best performers, **Jacob Internet Fund** (JAMFX2), didn't make our cut due to an outrageous 2.35% expense ratio.) We would suggest that even if you're completely bullish on technology that you only devote a small portion of your portfolio to one of these funds.

One that made our list is the **T. Rowe Price Global Technology fund** (PRGTX3). This multicap fund scours the globe for not only traditional tech firms, but also telecoms, Internet and infrastructure plays. With just 62 names, the fund has a fairly concentrated portfolio. In cases like this, we prefer to see an experienced pro at the helm. Jeff Rottinghaus has only been running this fund for nine months, but he's been a tech analyst with the company since 2001. And he's already proving his mettle. Right after he took over, some of his emerging market plays took a hit. Back here at home **Yahoo** (YHOO4), one of the fund's top holdings, dropped 25% in

the months after he became manager. But instead of making a knee-jerk reaction and selling it, Rottinghaus has been buying the Internet company. It's now showing signs of recovering. He's up 9.4% over the last three months, two percentage points better than the category average. We don't ordinarily concentrate on such a short time period. But we think it shows the slow and steady comeback of this sector. The fund is in the top 4% of its peer group over the longer five-year period.

Another option is to go with a well-regarded manager of an equity fund that happens to be heavy in the industry. A fund that didn't make our screen (since it's not classified as a tech fund) is the **Calamos Global Growth & Income fund** (CVLOX5), which has 30% of its assets in technology and telecom names like India's **Infosys** (INFY6), Microsoft, and Japanese videogame maker **Nintendo** (NTDOY7). This fund is in the top 19% of its peer group over the trailing decade. We also like **Old Mutual Large Cap** (OLCVX8) and **Old Mutual Focused** (OBFVX9). These two focused funds — they each own under 40 stocks — are managed by Liberty Ridge's Jerome Heppelmann. At Old Mutual Focused he has chalked up an average annual 12.5% return since 2003, putting him in the top 9% of his peer group. The fund owns names like Microsoft, **EMC** (EMC10), **Applied Materials** (AMAT11) and **Dell** (DELL12). "We don't consciously look to be overweight a particular industry but this is where our bottom up approach took us," he says. "We think there is a lot of bang for the buck [in tech]."

If you're able to tolerate some volatility you could invest in one of the 27 exchange-traded funds that track the industry. Since you can buy and sell ETFs during the day, we think these offerings might be favored by day traders or hedge funds looking to profit from blips in the market. That said, consider the **iShares Global Technology ETF** (IXN13), which owns 117 tech firms. With an average market capitalization of \$48 billion, these names tend to be the larger, more profitable firms on the market, a detail that will help minimize some of the ups and downs. The **Vanguard Information Technology ETF** (VGT14) is much more diverse, with more than three times the holdings, and cheaper, with a 0.25% expense ratio, vs. 0.66% for the iShares offering. Admittedly, Vanguard's ETF has a looser definition of technology, allowing it to invest in traditional names like **IBM** (IBM15), **Hewlett-Packard** (HPQ16) and **Oracle** (ORCL17) in addition to companies like Yahoo and **eBay** (EBAY18). Over the last three months both of these ETFs have been averaging returns between 7% and 8%. We have a word of caution before you go investing in tech stocks. We aren't anticipating another bubble and bust. But be prepared to be patient with these funds, even in the face of disappointment. After all, tech stocks are highly susceptible to even the faintest of bad news.