The hidden technology play

Technology stocks have provided amazing returns in recent years. There is little doubt that technology is an ever-growing part of our lives and a larger and larger part of the economy. Certainly companies providing technological services and creating technological products will prosper. Few would argue with any of these statements. Most would therefore conclude that investing in technology would produce above average returns. Unfortunately, the last statement is not necessarily so.

Common stocks are priced based on expectations for the future, not on their current value. This is an important point to consider because the investment implications are significant. A bank savings account increases in value only when interest is paid into the account. Its value is always equal to the deposits plus interest. This may seem like saying black is black and white is white, but it is more complex than that. Stocks increase in value when their future value is expected to be higher. Investors will often look to some future event that will impact a company's value and say they should buy or sell to take advantage of that event. If that event is widely known, the stock in that company already reflects the expected impact of that event. Stocks produce above or below average returns when the future is different from what is expected. Stocks that are more likely to produce above average returns are those for which the future is likely to be better than is widely expected.

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Let's look at an example. Investors expect Acme Tech, Inc. to increase earnings at 15% per year. The market places a value on it based on that expectation. If Acme delivers on the 15% expectation, its shareholders have an average rate of return and the price stays at the same level. Acme was valued accurately. But, if Acme only delivers 12%, that means the stock was valued too high; the expectations were too optimistic. The price immediately drops to the new level of expectation. The investors suffer below average returns.

On the other hand, let's suppose Investors expect XYZ, Inc. to increase earnings at 3% per year. The stock is valued in the market accordingly. If XYZ delivers on the expectation, the shareholders have an average return. However, if expectations increase to 6% per year, the price quickly jumps up to the new level and investors enjoy an above average return.

Acme Tech, Inc. has enjoyed 12% earnings growth, but delivered below average returns to investors. XYZ, Inc. grew earnings at 6% and delivered above average returns to investors. It does not matter that Acme Tech's growth was better than XYZ's. What matters is the relationship between expected growth and actual growth for each company.

The market set the initial price based on initial expectations. The future price changed as the future diverged from expectations. This is counter-intuitive to most investors. Investors assume that if the newspaper says a stock is worth $50 per share that is what it is worth. They believe that if the company grows the price of the stock will grow. Not so! Stock pricing is all about expectations. If the company is expected to grow, above average returns can be realized only when the growth rate is faster than expected.

This is what makes investing in New Economy stocks so dangerous. These stocks are valued at a huge premium based on the expectation that their future earnings will be tremendous. If reality is just a little less tremendous, these stocks will suffer.

How would you describe the expectations for New Economy technology stocks? How would you describe the expectations of Old Economy stocks? Which would you say has the greater risk of disappointment? Which would you say has the greater opportunity for improvement?

Clearly expectations for New Economy stocks are extremely high. It seems unlikely that expectations for the New Economy stocks could improve significantly, if at all. The expectations for Old Economy stocks are much lower, leaving more room for improvements in expectations.

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Looking beyond all this market analysis, all companies are using technology more and more every day. Companies selling technology will not be the only ones to benefit from it. Products are less expensive to produce because of technology. Services are less expensive to render because of technology. Companies selling technology face increasing competition. Perhaps the greatest "technology play" will be the Old Economy using the products and services of the New Economy.

Many say we have to look at the economics of the New Economy stocks differently to reflect a different world. This is true only in so far as it leads to future profitability. One point at which all companies converge is profitability. All companies exist to make a profit. The profit that New Economy stocks must make to justify current prices is difficult to fathom at best and impossible at worst.

Some believe that any measure of current activity is useless in the New Economy because future creative advances will overshadow everything that exists today. That may be true, but the most powerful advances often come from companies that do not yet exist. In fact, some of the advances may come at the expense of New Economy companies that exist today.

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Who will benefit from those undiscovered advances? Perhaps the Old Economy! Technology is only useful to the extent that it makes producing a product or providing a service more efficient and more profitable. The real technology play is in the Old Economy stocks that can currently be bought for more reasonable prices than the New Economy stocks.

To give these concepts reality let's compare Cisco Systems (a New Economy stock) and Ford Motor Company (an Old Economy stock). As of May of 2000 Cisco Systems was worth about $400 billion, Ford was worth $60 billion. For calendar 1999 year Cisco Systems earned about $2.5 billion; Ford earned about $7 Billion. So on the one hand you can pay $400 billion for $2.5 billion in earnings and on the other hand you can pay $60 billion for $7 billion in earnings. Ford is clearly earning more per dollar invested. Remember, though, the current market price is based on expectations for the future. Cisco is expected to grow much faster than Ford. Those expectations are already wrapped into the $400 billion you pay for the stock. Ford's stock price is depressed because of low expectations. In order to enjoy above average returns, the expectation of future earning has to improve. Which stock do you think is most likely to have an improvement in expectations?

No one knows what the future will bring.

Admittedly, these are only two stocks. There are other New Economy stocks that are not valued so high and there are other Old Economy stocks that are not valued so low. But the point is that just because New Economy companies are likely to prosper, does not mean that owning their stock will be profitable. And just because Old Economy stocks do not produce a technological product does not mean they will not benefit from technological advances.

No one knows what the future will bring. The New Economy may exceed expectations or it may fail to meet expectations. The one thing we can be sure of is that it will bring surprises. A diversified portfolio will allow the positive surprises to offset the negative surprises and produce a more predictable long-term result. A more predictable result creates more financial security.