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In a slow-growth world, technology stocks are trending again

August 14 2015, bySteve Rothwell And Michael Liedtke

In this April 16, 2015 file photo, a Nasdaq employee monitors prices at the Nasdaq MarketSite, in New York. The tech-driven Nasdaq hit another in a string of all-time highs last month as technology re-established itself as the dominant sector in the U.S. stock market, harking back to its last heyday during the Internet boom of the late 1990s. (AP Photo/Mark Lennihan, File)

Technology stocks are trending big-time as investors latch on to innovative companies racing ahead in a slow-growth world.

The tech-heavy Nasdaq is the best performing major U.S. stock index this year, gaining 6 percent as the Standard & Poor's 500 and the Dow Jones Industrial averages have wavered between small gains and losses.

The industry has re-established itself as the dominant sector in the U.S. stock market and currently accounts for 20 percent of the value of the S&P 500 index. That is tech's largest share since the dot-com bubble, and makes it the biggest sector in the market.

But the sector's success isn't universal. Some of the most recent earnings reports from big tech companies have highlighted both the good and the bad for the industry.

Here are three positive trends for tech, and two negative ones.

ROOM TO GROW

The economy is still expanding, but at a tepid pace.

Tech companies, however, are generating rapidly rising sales and profits as they disrupt older industries. And that is drawing in investors.

Many think the Internet boom that ended in 2000 was just the first leg in a wave of technology growth.

"The global digital economy is in its infancy. It's still being constructed," says Joe Quinlan, chief market strategist at U.S. Trust in New York. "So we have tremendous upside when it comes to social media, e-commerce, retailing, you name it."

Facebook's revenue jumped 39 percent in the second quarter. That compares with a 4 percent fall for S&P 500 companies in the period. Revenue at business software company Salesforce.com, which hasn't released its second-quarter figures yet, has tripled over the last five years.

SURPRISINGLY AFFORDABLE

Despite its run-up, the sector is not that pricey. In fact, tech stocks are trading at a slight discount to the market.

The average price-earnings ratio, a measure of how much investors are willing to pay for each dollar of earnings, is 16.2 for tech companies in the S&P 500. That is below the 16.6 ratio for the entire index, meaning that tech as a group is fractionally cheaper than the overall market.

"I don't see a valuations bubble," says Jeremy Zirin, head of investment strategy at UBS Wealth Management in New York. "It's not that there isn't froth in some areas, it's just not that pervasive."

Even after a 19-fold increase in the price of Apple's stock during the past decade, it's difficult to argue that it costs too much.

The P/E for Apple's stock is 11.7, considerably less than the average tech company and the overall market.

Google is another giant with modest valuations.

In this Tuesday, July 28, 2015, file photo, the logo for Twitter adorns a phone post on the floor of the New York Stock Exchange. While Google, Netflix and Amazon.com all soared to new heights after their recent quarterly reports, Apple, Twitter and Yelp were all ravaged for disappointing performances. (AP Photo/Richard Drew, File)

The Internet company's stock surged in mid-July after it reported better-than-expected earnings for the first time since October 2013. It rose further this month after it announced that it was changing its corporate structure. The change was welcomed by investors who want more transparency about how Google spends its money.

Investors also liked what they heard from Google's new chief financial officer, Ruth Porat, a Wall Street veteran, who has delivered a message of newfound austerity.

Businesses are still moving to the Internet and increasing their spending on advertising, trends that are far from over, says Matt Peron, managing director of global equity at Northern Trust, an asset manager. Those trends should benefit Google, the dominant force in online search and marketing.

That outlook, combined with a reasonable valuation, makes Google an attractive stock to own, he says. The company's P/E is 20.7, above the average for the S&P 500, but not excessively so.

DIVIDENDS

During the last Internet boom, tech companies developed reputations for being extravagant spenders. The money was spent chasing growth, not pleasing shareholders.

Nowadays, many of the larger, more established tech companies are returning cash to shareholders in the form of dividend payments.

Two-thirds of technology firms in the S&P 500 pay a dividend, according to S&P Dow Jones Indices, accounting for 15 percent of all dividend payments made by companies in the index. Some of the biggest names in the sector even pay better-than-average dividends.

Microsoft has a 2.6 percent dividend yield, which measures how much a company pays in dividends compared to its stock price. The S&P 500 average is 1.9 percent. IBM and Intel are also offering higher rates than the market.

Those quarterly payments are especially appealing to investors in an era of extraordinarily low yields in other investments, such as high-quality bonds.

WATCH OUT FOR FROTH

Investors may be getting carried away with the prospects for some stocks. Netflix is an example.

The company has been on an incredible run. Since bottoming out at a split-adjusted $7.54 in August 2012, the stock has soared 16-fold to peak at $126.45 on Aug. 6.

Netflix has added 38 million subscribers around the world during the past three years while expanding into dozens of countries. It's solidified its position as the leader in streaming video.

In this July 25, 2015 file photo, traders gather at the post that handles Yelp, on the floor of the New York Stock Exchange, Wednesday, July 29, 2015. While Google, Netflix and Amazon.com all soared to new heights after their recent quarterly reports, Apple, Twitter and Yelp were all ravaged for disappointing performances. (AP Photo/Richard Drew, File)

But investors are paying a high price for that growth. The P/E on the stock has jumped to 419 this year.

If those lofty expectations for earnings growth are not met, an uncomfortable adjustment could follow.

Twitter's stock, for example, has lost almost half its value from a peak in October as the company struggles to satisfy investors' demands for revenue and user growth. And online business review company Yelp has dropped 70 percent since its September high as it grapples with the market's expectations.

OVERSEAS EXPOSURE

Tech is the most exposed of all the S&P 500 sectors to demand from overseas.

About 60 percent of the sector's revenue comes from abroad, according S&P Dow Jones Indices.

As a result, earnings in the group will be hit if the dollar continues to strengthen, as it has done over the past two years. That's because a stronger dollar reduces the value of overseas sales and makes U.S.-produced goods more expensive for foreign buyers.

Microsoft and eBay were two technology companies that lamented the impact of the stronger dollar in their most recent earnings.

Tech companies are also vulnerable to weaker growth in economies overseas. That was illustrated this week when Apple slumped on worries that the Chinese economy was slowing more markedly than investors thought.

Apple's stock dropped 5.2 percent on Tuesday after the Chinese government devalued its currency, the yuan. Most analysts saw the move as an attempt to prop up growth.

The iPhone maker generates almost 17 percent of its sales from China.