

Picking Stocks

WITH ITS DRAMATIC RALLIES AND declines, the semiconductor sector demonstrates well the potential and danger of stock picking. The Philadelphia Semiconductor Index (SOX) and the Goldman Sachs Semiconductor HOLDRS (SMH) have both risen about 120 percent from the October 2002 bottom through February 2004 – a nice gain that saw all the stocks that make up the SOX and SMH rise. However, some did much better than others. While Intel (INTC) underperformed the SOX and SMH off the October low, Advanced Micro Devices (AMD) posted a more than 300 percent gain. This is a good example of how picking the best stock to own is more difficult than simply identifying the best company.

The SOX is made up of 16 stocks, while SMH holds 20, of which six and 12 have respectively outperformed off the market bottom. Stock return leaders include Advanced Micro Devices (AMD), Amkor (AMKR), Atmel (ATML), Altera (ALTR), Analog Devices (ADI), Broadcom (BRCM), National Semiconductor (NSM), Rambus (RMBS), Teradyne (TER), SanDisk (SNDK), Vitesse (VTSS) and Xilinx (XLNX). Laggards include Applied Materials (AMAT), Intel (INTC), Lattice Semiconductor (LSCC), Linear Technology (LLTC), LSI Logic (LSI), Micron (MU), Motorola (MOT), Novellus (NVLS), KLA-Tencor (KLAC) and Texas Instruments (TXN).

VALUE AND TIMING

When it comes to stock picking only two things really matter: finding overlooked value and timing the cycle. This is why Vitesse can be up over 1,000 percent off the market bottom. If you go to an auction, the best value is

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often found in an item few people are bidding for, while the most admired goods often represent the worst values. The same laws of supply and demand also apply to stocks. A good stock picker hunts for overlooked value; back in October

2002, very few people were bidding on Vitesse and the company had a lot of overlooked value. But timing is everything and even with that meteoric rise, Vitesse still represents around an 80 percent loss over the last three years.

Take a good look at that list of over- and under-performing chip stocks and you are going to see that the smaller companies generally did better than the bigger ones. Over time the stock market is efficient, with larger and smaller stocks turning in roughly the same performance. But there are distinct times where you have better chances of finding overlooked value in small stocks ... times like a bear market bottom after they have been pummeled by nervous investors worried about these companies' future prospects or even survival in a manner you don't see with an Intel. On the other hand, the later we move into this current market cycle, the better your chances of finding overlooked value in larger stocks.

PUTTING YOUR CHIPS DOWN

Reading my March column, you will note that at the end of January I turned negative on semiconductor stocks, believing they needed to grow into early-year valuations, and I swapped semiconductors (SMH) for software (SWH). But times change and a few key factors could get me to take another look at chip stocks. A move down to the 200-day moving average for the SOX that represents a double-digit negative loss would get me interested in chip stocks again, especially if it was accompanied by negative sentiment.

I personally view stock picking as an activity with significant risk (not too many folks figured Enron out before it blew up) and one that adds a lot less value than picking the right sector, country and style. Yet I will tell you what I would look for in stocks to purchase. If we get a good correction, consider buying those stocks that were hammered the most, because – as off the October 2002 market bottom – those are the ones that often perform best subsequently. In addition, semiconductor equipment stocks have had particularly rough going so far in 2004. I would probably lean towards stocks in this group over other semiconductor segments. The bottom line? Wait for the scariest moment this year and then gravitate towards the stocks that are the most frightening to purchase. The truth is the best investments you ever make are going to be the most uncomfortable. ☹

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