

Whipsawed

LAST YEAR, SEMICONDUCTOR STOCKS were up more than 75 percent as measured by the Philadelphia Semiconductor Stock index (SOX). At the low point in August of this year, however, the SOX had given back almost 30 percent. In 1999, semis were up over 100 percent but then fell 60 percent over the next three years – no laughing matter when you consider that it takes a gain of 150 percent to merely get back to breakeven after a loss of 60 percent.

This year, a lot of investors have been whipsawed by semi stocks. After a powerful rally in 2003 off the bottom of a three-year bear market, the semiconductor index started this year off well by rising as much as 10 percent in January. Indeed, many analysts couldn't say enough nice things about the sector and expectations were high. That, of course, is exactly why I recommended getting out of semi stocks in my March column after holding them throughout the previous year. But while luck shined on my exit, it didn't favor my re-entry – I recommended chip stocks again in my May column, but even with drastically lowered expectations and a bearish analyst community, the semis still had further to fall. After having reached 550 in January, the SOX fell as low as 360 in August.

BENEFITS OF THE BASKET

So did getting back into semiconductor stocks too soon seriously hurt the performance of my recommendations thus far for the year? Well, given their abysmal performance, it sure didn't help, but with six of my 10 recommendations outperforming the market I have done all right. At the end of August, my recommendations as a group were performing inline with the broad stock market as measured by the S&P 500 in spite of the very sharp down move in semis.

When it comes to investing there is a lot of truth in the cliché, "don't put all your eggs in one basket." Last year, chip stocks really helped my recommendations outperform the stock market, but other picks like utility and telecommunication stocks didn't. This year chip stocks have significantly underperformed the stock market, but those same utility and telecom recommendations that I stuck with are so far outperforming the market this year and helping me out. The lesson of diversification is an especially important one for investors to understand. There is a temptation for those who work in our industry to invest in the companies they know, but concentrating too much of your portfolio in volatile chip stocks can be very dangerous as this year is demonstrating.

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STAY THE COURSE

Because of their volatility, buying semiconductor stocks can feel like sitting at a high-stakes table in Las Vegas. Get the timing right, and you can make a lot of money fast, but get it wrong and your investment will shrink fast. Of course, there is an important distinction between the stock market and a casino: Gambling always favors the house, but if you buy and hold a diversified basket of stocks for several years, the historical odds are on your side. "Several years" is what makes all the difference, because frequent in-and-out trading is little different from gambling (and at least the casino will give you free drinks). And if you are trading semiconductor stocks, you are playing a high-stakes game indeed. But even if you are buying and holding semiconductor stocks for the long-term you would be best advised to put most of your money elsewhere.

Right now I am planning to stay the course with semi stocks, just as I did with utility and telecom stocks throughout last year and into this year amidst very low investor expectations. Today, sentiment has become so negative on the semiconductor industry that odds now favor positive surprises and a catalyst for stocks to move higher, as negative expectations have been largely priced in at these levels. Could these stocks move lower or simply not rebound for a while? Sure, and that's why I believe in diversifying across multiple investment themes where I think there is good potential for positive performance. Personally, however, I think reports of the early demise of this upturn are going to turn out to have been exaggerated, and chips stocks will move higher just as quickly as they zoomed lower earlier this year.

Stephen Brennan is an investor relations consultant with MCA, a leading Silicon Valley public relations firm, and a principal of Financia Capital, LLC., a San Francisco-based money management firm. He may be reached at sbrennan@mcapr.com or steve@financiacapital.com.