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Confidence Boost Eludes Chip Traders

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Call it profit-taking or call it cautiousness, but semiconductor investors don't seem quite ready to hold stocks beyond modest rallies. Chip stocks may have run nicely beginning in September, but they were flat in December and have started out poorly in the new year.

This has set investors up for the pending earnings season, to be led off by Intel's (INTC:Nasdaq) fourth-quarter financial results after Tuesday's closing bell. The world's largest chipmaker also will set expectations for the current quarter and announce its full-year targets on gross margin and capital spending, among other projections.

The coming weeks will be pivotal to chip investors as other companies too provide glimpses into full-year expectations. With traders always looking months ahead at expected business results when making buy/sell decisions, the initial tea leaves will be scrutinized closely.

History tells us that the first half of the year is weaker than the second half for semiconductor companies. Add to that an ongoing inventory bloat and chipmakers will have some hard slogging through the first quarter and into the second quarter.

Already this year, **Xilinx** (XLNX:Nasdaq) and **Micrel** (MCRL:Nasdaq) have cut financial targets; **Transmeta** (TMTA:Nasdaq) set plans to shift itself to an intellectual property company from a maker of its own chips; and **National Semiconductor** (NSM:NYSE) has cut 6% of its staff.

And National Semi's situation seems to indicate just how quickly business conditions have soured. Its factory utilization plunged from the mid-90% range at the end of August to the mid-60% range at the end of November. The recent job cuts indicate more than just a temporary blip.

These conditions will likely translate into a steady stream of dour-to-cautious predictions from companies concerning the coming months. That's not going to give investors confidence to carry stocks higher.

Patrick Ho, an analyst at Moors & Cabot, said he couldn't foresee anyone getting optimistic about the sector until April. "After the March earnings calls, if things progress positively, that's when people could get bullish."

People will become more willing to buy semiconductor stocks, however, only if they see marked improvements in business fundamentals.

So far, the semiconductor industry seems on track in 2005 for meager growth, at best, with targets showing global chip sales anywhere from down 10% to up 10%. Even if the industry hits

the high end of those expectations, it's a far cry from 2004, when it logged sales growth of around 30%.

And, unsurprisingly, expected industry sales growth has presaged stock performance. When a strong increase in sales was anticipated to take place in 2004, stocks accelerated in 2003, with the Philadelphia Stock Exchange Semiconductor Index jumping 76%. During 2004, as investors zeroed in on the possibility of lackluster sales growth in 2005 as well as the compounding impact of a lingering inventory bloat, the chip index dropped 16%.

For 2006, most growth projections aren't exceeding 10 percent, so conditions point toward continued tepidness.

"I understand the pressure to own these names, but I don't necessarily see why you would want to own these stocks 12 months before the end of a recovery," said analyst Eric Ross of Think Equity Partners, adding that big chip run-ups usually occur ahead of annual growth on the magnitude of 25%.

But growth like that isn't even on the radar. The Semiconductor Industry Association's most recent long-range forecast shows the industry growing only 14% in 2007.

But others aren't so sure such long-range forecasts should be taken as gospel. "The problem with estimates is 'garbage-in garbage-out,'" said Ian Fraley, managing principal with hedge fund Financia Capital in San Francisco. For Fraley, weak expectations plus weak stocks equals a buying opportunity.

"Whatever the market is expecting is already priced in," he said, adding that there's a much better chance that companies will exceed current targets than that they'll disappoint. This will be the catalyst that drives stocks higher, Fraley noted.

Still, other investors are trying to make the muted environment pay off. Kim Arthur, managing director of San Francisco's Main Management, has set his portfolio for a year of single-digit returns, using the sale of covered call options, known as a "buy write" strategy.

(An investor writing a covered call already owns the underlying security, that's the "covered" part of the transaction. By selling, or writing, a call option against his stock, he's limiting the upside to a price move higher, but generating income from the sale of the option. The option income lowers the risk -- and cost basis -- of the overall portfolio.)

Arthur resurrected the strategy from the dustbin of the 1970s and early 1980s, when the market couldn't break out of a sideways pattern. He said he'll surrender some upside if the market moves more than 20%, but he should outperform in a down-to-flat environment.

"People hear 'option' and run the other way, but this is so conservative," Arthur said. "It's like being a landlord who rents out his property while retaining the underlying building with an agreement to allow the renter to buy the property at a higher price."