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Chip Bulls Lie in Wait

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Priorities. People have other priorities. That has to be what's going on with chip stocks. Oil, bonds, the withering dollar, Iraq. All seem to be taking precedence over the semiconductor sector.

The past week brought four pretty positive reports from three distinctly different regions of the chip landscape, but the stocks as a group ended the week essentially flat with the earlier week.

"Can anyone get excited about tech stocks these days?" asked **Ian Fraley**, managing principal with San Francisco-based hedge fund Financia Capital. "I don't know anyone who can, and I live in Silicon Valley. I love that."

Say what?

Fraley's excited to be holding tech names when nobody else wants to, you see, because he thinks improving fundamentals mean it's only a matter of time before others come around to recognize the return and value that these stocks will provide. His portfolio is heavy technology stocks and, within that, he's heavy semiconductor stocks.

"It's extremely unusual for any particular style or sector to outperform or underperform in a big way for several consecutive years. It doesn't happen often and when it does, it generally indicates that a big reversal is about to happen," he added.

Fraley said there remains lingering wariness to stocks, especially tech stocks. But he compares equity values to risk/reward scenarios of alternative investments, like real estate and bonds, and he sees stocks as an asset class that is "absurdly cheap."

"Money always chases the highest-yielding asset and the only thing that stops that is risk aversion," he said.

It's a pattern that can be seen in semiconductor stock charts.

The Philadelphia Semiconductor Index, or SOX, doubled from early 2003 into the start of 2004, as sector growth projections for 2004 proved the strongest in years. The index dropped once inventory concerns started to spook investors and growth estimates for 2005 proved anemic. After nine months of declines, the SOX sat at a 14-month low and then marched 30% higher into December. Declines started anew and the index fell into January, hitting a three-month low before again rallying 15% to test December highs.

That brings us to the present, with **Intel** (INTC:Nasdaq), **Texas Instruments** (TXN:NYSE), **National Semiconductor** (NSM:NYSE), **Xilinx** (XLNX:Nasdaq) and **Altera** (ALTR:Nasdaq) all providing investors in the past two weeks with financial reports that were mostly positive. But what have the stocks done? Nothing. The chip index is down 1.8% from where it was one month ago.

The SOX added a few basis points Monday morning after **LSI Logic** (LSI:NYSE) raised its first-quarter sales outlook by 10%, citing strong retail and storage component demand.

But Fraley said the lack of follow-through isn't necessarily a bad thing. "I actually take that as healthy. These things never move in a straight line," he said. "A sideways move and it feels like everything is over. By the end of the year we will look great."

The first quarter is typically the weakest quarter for semiconductor companies. The second quarter, too, is weak. With companies sticking to statements and expectations about the just completed three months and the coming three months, investors don't have much on which to trade -- at least until discussions start about the third quarter.

But disinterest doesn't necessarily spell doom. "I don't know that [semiconductor] fundamentals are any worse now than they were two months ago. In fact, they're probably better," said Scott Curtis, managing director of trading at Kinetics, a New York-based money management firm. "Perception has really overwhelmed this group."

He compared today's lack of interest in chips to a similar trend three years ago in the energy sector. "No one wanted to buy **ExxonMobil** (XOM:NYSE) in the \$30s, but they'll buy it now in the \$50 and \$60 range," he said.

That's little comfort to investors in the semiconductor arena right now. But the freeze might be thawing. If fundamentals can consistently improve, the money should follow.

And, for the most part, semiconductor companies are in a good position to do this. Despite the industry's cyclical nature, companies have record amounts of cash on their balance sheets and costs remain well under control. Combine that with improving demand -- even if it is relatively tame -- and the conditions improve for more predictable stock moves.

But many investors have been burned before by trying to time the chip cycle and will likely wait until evidence of consistent growth is readily apparent.

"If I feel this is sustainable, then I will start looking at these types of assets," said Forbes Watson, a small-cap portfolio manager with Voyager Asset Management. "The problem with this industry is that it's cyclical and it fights technological obsolescence so quickly. Buying them and owning them for six months of the year is market-timing and speculation. I don't do either one."

Watson runs about \$650 million, with about 25% of it in the technology sector. But the tech holdings are in software and services, not in hardware. He said recent talk out of the semiconductor industry has been fairly positive, but he needs to hear more.

"I will be late to this party," Watson said. "I don't know when it begins, but I'm willing to wait until it starts and then be fashionably late."

