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BARRON'S COVER

Live Wires

Tech stocks have been super-charged in recent months. Just how much juice do they have left?

By MARK VEVERKA

Silicon Valley is humming again, and so are technology shares. Eight to buy, and three to avoid. Why Google is inexpensive.

IT'S TAKEN SIX YEARS, BUT THE dot-com crash is receding in most investors' rear-view mirrors. And the road ahead for the technology business, despite a few bumps, looks wide open and inviting. - For the first time since 2000, tech-heavy growth-oriented mutual funds saw an influx of money in August as buyers tried to catch up with a sector whose indexes have about doubled the Dow Jones Industrial Average's 10% gain in the past 12 months. This year looks like just the

second in the past seven in which tech returns will top the broad market's performance. Apple (ticker: AAPL) shares have soared 117% in 2007; Nokia (NOK) 96%, Google (GOOG) 46% and Amazon.com (AMZN) 124%. - "This might be the start of a new trend," says Paul Wick, a managing director of J&W Seligman and head of its technology-investing group. He and his colleagues were among those who provided some perspective on the brighter picture for tech shares (as well as some stock picks and pans). - A quick tour of your favorite electronics superstore reveals much about the state of technology. Consumers are snapping up MP3 players, digital and video cameras, computer-game consoles, flat-panel TVs, personal-navigation systems, notebook computers and mobile e-mail devices. Increasingly, they aren't even going to the mall; they're buying them online.

In a role reversal, corporations now are trying to apply the advances in personal technology by harnessing the power of e-commerce, instant messaging, blogging and digital imaging to improve their internal communications and productivity. More generally, corporate spending on information technology in 2008 is expected to rise less than originally thought, though it still generates a couple of our stock picks this year.

"Consumers are now the beneficiaries of innovation, replacing government and the enterprise, which used to be first to adopt," says Roger McNamee, co-founder of Elevation Partners, a private-equity fund focused on media and communications.

The Morgan Stanley Technology index (MSH) not only has returned roughly 20% for the past 12 months to the Dow's 10%, but also, some of its constituent parts have done far better than that. The Dow Jones U.S. Computer Hardware index, for instance, is up nearly 48% over the same time period.

Robust personal-computer sales have been a pleasant surprise. Wick says PC sales growth has clocked in at 14% this year compared with 12% in 2006, driven by a relatively new phenomenon: multiple laptops in the home, thanks to ubiquitous household Wi-Fi networks. Apple revealed last week it had shipped 2.2 million Macs last quarter, its best ever for computer sales.

This sort of hardware is beginning to converge with other forms of consumer electronics to produce potentially revolutionary smart phones like Apple's iPhone as well as similar devices from Research In Motion (RIMM) and Nokia. The PC companies and the consumer-electronics giants now are competing with the telecom titans that crank out nearly one billion wireless phones a year. All roads lead to the mobile Internet.

A Growing Geek Squad: Gadget-loving consumers have displaced business as the driving force in technology sales and innovation.

"The strength in the wireless-handset industry is good for the whole electronics industry," Wick notes.

Of course, there's a real question as to whether the consumer -- suffering from tightening credit conditions, falling housing prices and high energy costs -- can continue to support this whole supply chain, particularly if the economy turns down.

But the strongest arguments seem to back tech's ongoing out performance. Standard & Poor's projects 24% growth for tech earnings in 2008. And Fed rate cuts should help multiples, says Walter Price, co-manager of the Allianz RCM Technology (RAGTX) fund. Other bullish indicators: strong cash flows and lower share counts due to buybacks and reduced option grants. Plus, American tech companies get more of their revenues from outside the U.S. than nearly any other sector. Thus, a weak dollar and a recession could have less negative impact on tech, our experts say.

To help us pinpoint some tech stocks to buy -- and some to avoid -- we spoke with Price; Seligman's Wick and his associates, Reema Shah and Ajay Diwan; RS Investment's Allison Thacker; Ed Snyder of Charter Equity Research, and Glen Kacher of Integral Capital Partners, a technology hedge fund. A couple of other trusted sources also were consulted. Although we long ago picked Apple (Barron's, "Mac Attack," July 17, 2006) and like Research In Motion, too, we decided to steer clear of them because the shares have moved up so much.

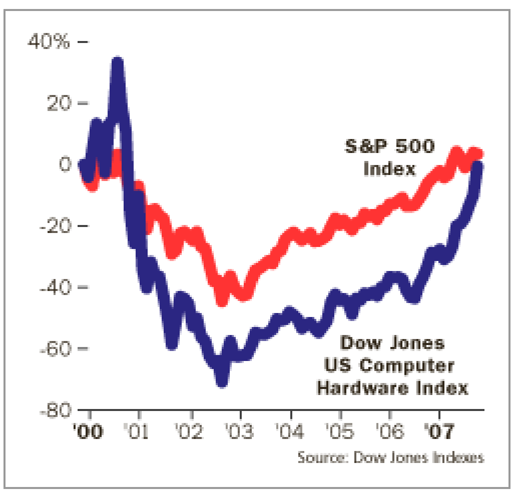
LET'S START WITH THE elephant: Google. While many skeptics find fault with this juggernaut, Price, Kacher and Shah still recommend it. Shah says "you will continue to see them dominate Yahoo ! [YHOO] and Microsoft [MSFT]." As more media-advertising revenue shifts to the Web, there is nobody better positioned to capture it than Google, which she argues is inexpensive relative to its growth rate. Its forward-looking P/E of 32.7 is lower than Amazon's 57.3. She also predicts that Google will offer its own wireless-phone handset. Shares traded around 669 on Thursday, but Shah sees them climbing to 750.

As we noted in a recent cover story ("Nokia's Star Turn"), Nokia, with its manufacturing prowess in mobile handsets, should be able to gain market share and expand margins well into 2008. Although they've jumped since we wrote about them, Nokia's American depository receipts, at 39, are still priced for growth at about 18 times forward-looking earnings. The emerging mobile Internet can only help Nokia.

Nokia has begun to move into mobile services like global-positioning systems, a promising area. But Kacher of Integral Capital, suggests the Dutch company **TomTom** (TOM2.Netherlands) may be the best play in these digital-tracking products. It's not as well known as U.S. rival Garmin (GRMN), but he thinks it has an edge if it can pull off a proposed acquisition of **Tele Atlas** (TA.Netherlands), a respected digital-map maker. Garmin and TomTom control about 65% of the digital- positioning market, and Kacher believes both should shine. TomTom -- with a price-to-earnings multiple of 24 versus Garmin's 34 -- is less expensive.

ONE OF SHAH'S FAVORITES IS an exception to our consumer-driven theme: BMC Software (BMC). The company is expanding profit margins despite toiling in the mature business of supplying software for mainframe computers. Why? Big corporations have been spending more on their systems in recent quarters. Pro forma operating margins, which better reflect cash flow, have jumped from single digits to about 24% in the past few years, she notes. Shah thinks they can hit the low 30s.

BMC is also an inexpensive way to play the boom in virtualization software, which helps companies make better use of their server capacity. The pioneer in the field, VMware (VMW), has seen its shares rocket 290% higher since its August IPO. BMC is a partner with VMware, and its software helps companies deal with the complex task of adding virtualization. BMC trades at about 16.6 times forward earnings; VMware fetches an unreal 117 times earnings. Shah thinks BMC shares, at 31.73 last week, could top 40 in 12 months.



Back in Action: After trailing the S & P for six years, computer stocks are poised to retake the lead.

Her colleague Diwan is a fan of disk-drive maker Seagate Technology (STX), which should benefit from the uptick in personal-computer sales, the surge of interest in digital-video recorders and the high demand for more storage due to multimedia. After suffering in an industry-wide pricing struggle, Seagate was rejuvenated by private-equity firm Silver Lake Partners.

Now Seagate is back on top of its game, Diwan says. As an industry leader with a $14 billion market value, it should benefit from industry consolidation that supports pricing. Plus, Seagate earnings are more visible owing to more straightforward accounting in the industry. At around 26 last Thursday, the stock is trading at

10.1 times forward earnings, and Diwan thinks it can hit 30-33 a share in the next 12 months.

"E-commerce has really ripped it up this year largely due to Amazon," says Thacker, co-manager of the RS Information Age fund (RSIFX), which is up about 29% for 2007. One niche is serving as a specialized outsourcer for companies, particularly traditional retailers. Amazon, for instance, handles much of Target's e-commerce operation. But the online-retailing giant is reducing its role in this segment, creating more opportunities for outfits like GSI Commerce (GSIC) of King of Prussia, Pa.

GSI, with $672 million in revenues, can provide total e-commerce services from Website presence to merchandise fulfillment and shipping. Or companies can order portions of those services a la carte. On Thursday, a report from comScore, a digital-media research shop, said third-quarter online retail revenues rose 23% over a year ago, to $28.4 billion. GSI already partners with Dick's Sporting Goods (DKS) but has won new accounts at Toys "R" Us and Nautica.

RS Funds isn't allowed to publish price targets, but Thacker says her fund's general goal is to double the value of its investments. GSI shares were trading around 24.71 last Thursday.

Another of Thacker's e-commerce plays is Digital River (DRIV), an Eden Prairie, Minn., provider of online software delivery, which she likes for its valuation. Digital River handles the online-software store for security-software behemoth Symantec (SYMC), whose Norton anti-virus products can be downloaded via this route. Other service customers: Microsoft Office and Sony.

Selling at 22 times 2008 earnings after a recent drop to 45, the stock is cheap by tech standards, says Thacker. Plus, it has $13 a share in cash. The slide resulted largely from what she says are unfounded concerns that Symantec, which accounts for about 40% of Digital River's $328 million in annual revenues, could take its business in-house. Thacker views that as unlikely. The company beat quarterly earnings estimates last week.

The San Francisco-based money manager also likes application-software outfit PROS Holdings (PRO), another pick that strays from our consumer theme. Thacker thinks that one of the next mega trends in software is going to be predictive analytics and pricing optimization. PROS was created to tackle airline-fare pricing, but was forced to diversify after 9/11. Since then it has added promising new clients in manufacturing, distribution and services; airlines will still account for about 34% of its $61 million in estimated 2007 revenues. Its software is popular because it can do things like making sure a job bid is profitable.

Revenue is recognized upon implementation and delivery of the product -- rather than contract closing -- which provides more visible and consistent accounting for investors. The Street sees 2008 revenues growing about 25%. Thacker thinks that can continue.

Shares were trading around 13.50 last week and the consensus price target is 16. Thacker believes that's low.

SO WHAT LOOKS VULNERABLE? Charter Equity Research analyst Ed Snyder is bearish on Motorola (MOT). While value investors again last week were snapping up the shares in anticipation of a turnaround (see Plugged In, page 40), Snyder says there's little evidence the wireless-handset makers' restructuring is more than skin deep. Management guidance for the December quarter was bearish, he says, though the company has stemmed market-share losses. Cost-cutting should aid margins in the short-term, which helps explains the recent 19.6% rally to a price of 19.30. Still, Snyder argues that until the company has a post-Razr phone platform, financial engineering doesn't offer a fix for the next few quarters. The shares, he says, could still slip to 15 unless there's more progress.

Table: Tech-Stock Picks and Pans

Nvidia (NVDA), the maker of graphics-centric microprocessors, has been a huge beneficiary of the digital-imaging revolution in computers, gadgets and wireless handsets. One bearish hedge-fund manager warns that all good things must come to an end for this stock, which last week was trading near 35, or 53.6 times trailing earnings. While the December quarter will still be strong, the manager predicts '08 will not be kind to Nvidia investors. Changes in component sourcing by Intel and Advanced Micro Devices mean Nvidia will lose share next year and see a drop in growth. The fund manager thinks the shares could fall up to 50%.

Seligman's Wick is down on Electronic Arts (ERTS), contending that its game portfolio is tired. Sales of EA's Madden Football for Sony's PS2 console fell 46% in September versus a year ago, according to NPD, a market-research firm. The surprise emergence of Nintendo's Wii machines has caused EA, which doesn't have as many Wii offerings, to lose share. Trading at about 57, or 29.9 times forward earnings, "Electronic Arts is the most expensive computer-game stock, yet it has slower growth," says Wick, who pegs the shares' downside in the mid-40s.

If current robust trends persist in tech, however, stocks with dimmer prospects will remain an anomaly.
