

## Information Technology Stocks vs. S&P 500

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We believe the longer term outlook for the technology sector remains constructive. To stay globally competitive, corporations should continue to search for ways to enhance productivity. Both the tech sector and the market in general look attractively valued. The sector also appears to be "under-owned," as investors who were burnt by the "tech bust" have been reluctant to jump back into tech stocks. However, investor memory should be starting to fade. If we are right on our optimistic outlook for the economy, tech stocks could lead the market higher later this year. The only thing holding us back from a greater overweighting in this sector is the recent weakness in the overall market and renewed weakness in the relative strength of the tech sector.

### Long-term fundamentals are positive

Technology continues to grow as a share of GDP and is likely to do so well into the future. Globalization and its impact on competition are limiting the ability of corporations to raise prices. At the same time, a global shortage of skilled labor, historically low unemployment and a likely increase in the U.S. minimum wage should put upward pressure on wages and downward pressure on profit margins. In order to maintain margins, we believe corporations will have to increase capital spending in general and information technology (IT) spending in

particular to enhance productivity. The winners in a global growth environment will be corporations that can maintain their margins as top line growth rises. Technology itself should create demand for more technology. With technology rapidly innovating, corporations will likely continue to add new technologies to their business models to remain competitive and out of fear of being left

behind. As prices come down for existing technologies and as new innovations come to market, consumer spending on high tech gadgets is likely to continue as well. The problem with faster innovation is shorter product cycles and commoditization. The trick is to find IT companies that are the innovators. Technology almost by

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### Information Technology vs. S&P 500 Monitor

Valuation	Current Bias	Tendencies
Absolute Value	Positive	Earnings, cash flows and sales yields
Relative P/E	Neutral	Watch for valuation extremes
Relative P/E vs. Russell 2000 (small cap)	Positive	Watch for valuation extremes

### Economic Catalysts

Economic Catalysts	Current Bias	Tendencies
Economic Cycle	Positive	Up-cycle favors IT
Market Cycle	Positive	Late-cycle favors IT
Earnings Revisions	Positive	More stocks reporting positive eps revisions
Relative earnings growth	Positive	Relative forward earnings positive
ISM Index	Neutral	Expanding manufacturing sector is positive
Leading Economic Indicator	Negative	LEI above 2% y-y is positive
IT New Orders	Negative	High and rising is positive
IT New Orders /Shipments	Neutral	High and rising favor is positive
Unfilled Orders/Shipments	Negative	IT backlogs rising/falling relative to total
IT Production/ Total Prod.	Positive	High and rising is positive
Fed Policy	Neutral	Underperforms after last tightening
Dollar	Positive	Weak dollar (y-y change) favors IT
Equity Risk Proxy	Negative	Low and widening credit spreads negative

### Price Action

Price Action	Current Bias	Tendencies
Relative Momentum	Neutral	IT Sector vs. S&P 500
Long-Term Mean Reversion	Positive	Long-term underperformance is positive
Relative Volume	Negative	NASDAQ vs. NYSE Volume
Breadth (Hi/Low, AD)	Positive	Breadth in line with price trend is positive
% Bullish Ratings	Positive	Above 60% is bullish
Tech % Total Funds	Positive	Low = pessimism = bullish
Short Interest	Positive	High shorting is positive. Trend
Analyst Sentiment	Positive	Bearish consensus is bullish
Overbought/Oversold	Neutral	Overbought is bearish
Seasonality	Negative	August-February positive
NDR Sector Rank	Negative	Ned Davis Sector Model

Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bear Stearns

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definition is innovation, and we believe we have only seen the tip of the innovation iceberg.

### Valuations are attractive

At 22 times forward earnings, the IT sector of the S&P 500 is inexpensive, particularly relative to small cap stocks trading at 21 times earnings. However, relative to the S&P 500, the sector is at best neutrally valued.

### IT is underowned

The IT sector currently comprises 14.9% of the S&P 500, which is above the 11.3% mean going back to 1972. However, as technology has become a larger share of GDP, IT earnings as a percent of the S&P 500 earnings have risen to 10.7% from the long-term mean of 5.8% over the period of 1972-2007. The IT sector appears under-owned and should be a larger percent of the S&P 500 given the rapid relative growth in relative earnings. In addition, the percent of IT assets as a percent of total domestic mutual fund assets has fallen to 14.5% from the long-term mean of 27.5%

### Economic and market cycles

Historically, the IT sector tends to do well in the latter stages of a bull market and when the economy is still in an up cycle. If we are correct in our base forecast for stronger growth in the second half of the year, the environment should be conducive to value recognition in the IT sector. We believe tech stocks should outperform as economic growth reaccelerates later in the year.

Although IT orders and backlogs have been soft, given lean inventories, once

orders increase, production should turn quickly. Order flow has been hindered by slower economic growth and the impact of Microsoft Vista. Order growth should start to improve in the second quarter, and earnings growth in the Tech sector is expected to be much stronger than for the S&P this year at 15.3% versus 11.6%.

### Relative Momentum has faded

The IT sector has underperformed the S&P 500 over the last one year and three year periods. We believe it is due to catch up as returns revert to mean levels. Since the end of 2001, the IT sector has underperformed the S&P 500 by over 30% and small cap value stocks by 68%. With the excesses of the late 1990's wrung out, IT may be poised for a period of outperformance. In the second half of last year, IT began to outperform but hit a speed bump when the market corrected this year. If as we expect stocks move higher as the year progresses, IT could once again outperform.

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