# Mitch on the Markets

## Tech Stocks: Separating Hype from Performance

By Mitch Zacks
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Earnings season is in full swing, which gives investors an opportunity to ditch the news cycle for a moment to focus on revenues, cash flows, and profits. Or, as I would argue, the factors that matter most to equity investors long-term.

This week I want to focus on technology stocks. We've seen several IPOs in 2019 that have made big splashes and garnered a lot of exciting media coverage. But a closer look reveals that for all the hype and rapid gains, many of these companies are yet to turn a profit. Uber, for example, in its first quarterly earnings filing in Q1 posted losses of $1 billion on revenue of $3.1 billion. The company is growing at rapid pace, but losing $1 billion in three months is steep.[1]

These figures are a far cry from recent earnings reported by tech behemoths like Amazon and Google. Profit in the second quarter for Amazon was $2.63 billion (yes, billion), which is more than double the profit it made in the first quarter. Alphabet's (Google) numbers are even more staggering, with a reported $9.2 billion second quarter profit on $38.9 billion in revenue – a 19% increase from the same quarter last year.[2]

This example of Uber vs. Amazon and Google is, in my view, a cross-section of what it means to invest in the technology sector today. Investors must assess the value of investing in established technology companies like Intel and Microsoft – which often deliver reliable earnings with steady dividend payments – against up-and-coming players in technology that tend to be headline grabbing, 'disruptive,' and characterized by exponential growth, potentially high returns, and *negative* earnings.[3]

*The question is, where and how to allocate?*

### Focus on Cash Flows and *Future* Cash Flows

In my view, the winners in the technology space will be the corporations that can improve their return on equity (ROE) while consistently growing revenues and margins. In other words, we need to see how companies can grow earnings consistently and create new sources of cash flow in the future. Microsoft and Amazon's burgeoning cloud businesses are a great example, in my view, of how a technology company can step into a new business line for new sources of cash flow.

For investors looking ahead 10, 20, even 50 years, you'll want to assess how well-positioned a company is to either create or apply advancements in technology like 5G connectivity, robotics, Artificial Intelligence, and machine learning to enhance productivity, expand manufacturing capabilities, and ultimately sell and do more at a lower cost. The cash flow generation potential of these applications is virtually unlimited given their asset-light business models, near-immediate global penetration, and the vast array of essential and life-altering services they provide to global consumers.

Taking the long-term view – and given the many unknowns that come with future technologies – may give the impression that an investor needs to make a calculated bet for where, how, and when to invest. But I don't think it has to be that complicated. In my view, if an investor follows the cash flow versus the news flow it will become clearer which companies have competitive advantages and sustainable business models. Getting this right takes great scrutiny and analysis from a bottom-up standpoint, something we strive to do here every day at Zacks Investment Management.

## Bottom Line for Investors

It's been a major theme for much of the current bull market: the biggest technology companies have been outperforming during rallies, pulling the broad index higher. 2019 is no exception. Through last Friday, Microsoft, Apple, Amazon, and Facebook have delivered combined performance that accounts for 19% of the S&P 500's total return for 2019 (note: all of these companies are very profitable).[4]

Emerging technologies stand to fuel growth and cash flow for decades and generations to come. For investors, having broad, diversified exposure to equities in tech and elsewhere means giving yourself the ability to participate in that growth as it likely unfolds.

**About Mitch Zacks**

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Techcrunch May 30, 2019.
https://techcrunch.com/2019/05/30/uber-earnings/

[2] The Wall Street Journal, June 25, 2019.
https://www.wsj.com/articles/google-posts-strong-earnings-as-threats-mount-11564086496?mod=djem10point

3 BlackRock, June 4, 2019.
https://www.blackrockblog.com/2019/06/04/technology-future-cash-flows/

[4] The Wall Street Journal, July 21, 2019. https://www.wsj.com/articles/tech-rally-powers-record-gains-for-stocks-11563701401

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