Mitch on the Markets

How Market Pullbacks May Boost the Case for Tech Stocks

By Mitch Zacks
CEO & Senior Portfolio Manager

It's no secret that technology stocks, led by FAANG[1], have been posting strong positive gains in this bull market. You've probably heard about the outperformance over the last few years, which might also lead you to reasonably conclude that technology stocks are not cheap.

You'd be right – technology stocks trade at more than a 10% premium to the broader market, which is significantly higher than the post-crisis 4% average.

But in my view, a closer look shows that maybe technology stocks *should* be trading at a higher premium, given that companies in the tech space are more profitable than the S&P 500 average. The current return-on-equity (ROE) for tech names is over 30%, which is nearly double the average ROE for S&P 500 companies.[2] If you look at technology companies through a lens of price-to-cash flow versus the traditional price-to-earnings, the premium starts to make more sense.

Because technology stocks are in high demand and trading at a premium, they also tend to get beat up badly during market pullbacks. The significant market drawdown late last year – which was technically a bear market for a single day – wreaked disproportionate havoc on the FAANG names. The S&P 500 fell around -20%, but Facebook plunged -28.4%, Amazon -36.3%, Apple -37.2%, Netflix -40.2%, and Alphabet -20.2%. With the exception of Alphabet (Google), these declines are more in-line with what we'd expect from big bear markets.[3]

But that's also precisely why market pullbacks can boost the case for long-term ownership of quality tech stocks.

As I write, the S&P 500 is up approximately +20% for 2019, but technology stocks as measured by the exchange traded fund IYW is up nearly +30%.[4] In short: getting beaten up on the way down can often give us long-term investors attractive entry points.

If you believe that there is a strong case for secular growth in the technology sector – which I do – then it follows that high-quality technology companies with competitive advantages have an opportunity to potentially deliver strong earnings growth for several years to come. Market pullbacks just make them temporarily cheaper.

Risks to Watch Closely

In a word: regulation. Now more than ever, technology companies are dealing with scrutiny from all angles. The Justice Department is currently conducting an antitrust review of Alphabet's Google unit as well as Facebook and Amazon. Earlier this month, 48 Attorneys General – led by Texas AG Ken Paxton – announced they were joining together for an antitrust investigation of their own into Google's practices as they relate to online advertising markets.[5]

As pressure builds, the forward-looking environment becomes less certain, since regulation could pose a threat to future earnings. At the same time, the right kind of regulation could also benefit new entrants and create entirely new revenue streams into the sector. I'd argue that regulation can create speedbumps for the biggest companies, but that it won't stop the growth engine overall.

But here's the real kicker, which I also think matters the most: *any regulatory breakthrough that results in real legislation is likely to take years.* 2020 is also an election year, meaning that big ticket legislation that is not passed during the balance of 2019 is not likely to see the light of day in Congress for another couple of years. If anything, I'd expect any regulation targeting the tech sector to be small at first, which I do not believe will impact earnings in a meaningful way. The sector remains highly attractive even with the added scrutiny.

Bottom Line for Investors

If you've been following my columns for some time, you almost certainly know that I don't advocate for market timing and that I also don't tend to put too much emphasis on technical analysis. So, it's important to note that my case for tech stocks during market pullbacks has everything to do with owning high-quality, highly profitable companies that have strong secular growth cases – and trying to buy them cheaply.

At the end of the day, uncertainty surrounding the regulatory environment and the trade skirmish may have some influence over pricing in the near term, but longer term I think high-quality technology companies will continue to be a growth story. These are the types of companies we'll continue to seek out in our earnings-focused approach, which are incorporated into Zacks Investment Management strategies where appropriate.

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] Facebook, Amazon, Apple, Netflix, Google (Alphabet)

[2] BlackRock, August 20, 2019. https://www.blackrockblog.com/2019/08/20/can-a-growth-scare-benefit-tech-stocks/

[3] Barron's September 11, 2019. https://www.barrons.com/articles/apple-amazon-and-other-top-tech-stocks-51568144526?mod=RTA

[4] Yahoo Finance, September 23, 2019. https://tinyurl.com/yyh6xrf3

[5] The Wall Street Journal, September 9, 2019. https://www.wsj.com/articles/attorneys-general-launch-probe-of-google-11568055853?mod=djem10point

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