A risky game of chicken

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Are individual investors getting pulled into a game of chicken?

Some market experts say that hedge funds, momentum traders and small, aggressive mutual funds are trying to pump up their own returns, and hence their bonuses, by playing a game that works like this:

They pick a sector that has been beaten down and is primed for a bounce. It helps if the sector is inherently volatile. They like to target low-price stocks because a small price move produces a big percentage gain.

The players then pile into the stocks, hoping to get the prices high enough to lure greater fools who will buy their inflated shares before the whole thing comes crashing down.

For the past two months, they've mainly been using tech stocks, which are rising for no apparent reason.

"These guys are playing a game of chicken -- who can get out last before the stocks go off the cliff," says Fred Hickey, editor of the High Tech Strategist Newsletter.

The professional drivers are using remote control. "It's not their money in the driver's seat. They say, 'If it goes off a cliff, I'll close my hedge fund and start another,' " says Hickey.

Until recently, individuals refused to get drawn into the game, if indeed there is one. Each month from June through October, investors pulled more money out of stock funds than they put in.

In the week ended Nov. 26, however, stock funds had net cash inflows of $3.5 billion, according to AMG Data.

Most of the money went into international-stock funds, followed by tech funds, which had their heaviest inflows since April. AMG President Bob Adler says the inflows were significant, but one week does not make a trend.

The chicken game sounds like a conspiracy theory, but how else can you explain the surge in tech stocks?

Since the market bottomed on Oct. 9, the eight best-performing industry groups in the Standard & Poor's 1500 index are all tech- and telecom-related. They range from wireless communications (up 112 percent) to computers (up 46 percent).

Even Internet stocks, once left for dead, are partying like it's 1999.
And it's not just EBay.

On Sept. 30, Barclays Global Investors announced it would close its Internet iShares -- an exchange-traded mutual fund of Internet stocks -- on Dec. 5 due to a lack of interest.

Since the announcement, however, the price of the Internet iShares is up 48 percent. Despite the run-up, Barclays still plans to liquidate that fund and two others after the close of trading today.

It's hard to find fundamental reasons why tech stocks are booming.

Demand across virtually all sectors remains weak.

Last week, Tech Data, the nation's second-largest distributor of computer products and a barometer for the industry, said its fourth-quarter sales would miss targets due to a pervasive slowdown in tech spending.

The only way most companies can increase earnings is by cutting costs or stealing market share.

Here's what passes for good news these days: A company that slashed fourth-quarter earnings estimates in October now says things aren't quite as dire as it had thought.

Investors are expecting positive news today from Intel's mid-quarter update.

Analysts predict Intel will say fourth-quarter revenue will come in at the upper end of its previous forecast of $6.5 billion to $6.9 billion. That compares with $6.98 billion in the fourth quarter of last year.

OK, so tech stocks are still way below their peaks, but that doesn't mean they're cheap.

Applied Materials, the big chip-equipment maker that is laying off 11 percent of its staff, is trading at 75 times earnings. That's last year's earnings and next year's expected earnings, both around 20 cents per share. A PE ratio of 75 is outrageous for a company with flat earnings.

If you look out to 2004, when Applied Materials is expected to earn 50 cents per share, its PE drops to 30. Better, but still no bargain.

Intel, meanwhile, is trading for around 40 times earnings. "For eight consecutive years, from 1988 to 1996, Intel's PE ranged from 8 to 14. It never got higher than 14," says Hickey, who has been bearish on tech stocks for several years.

Harvey Baraban, an educator and trader in San Francisco, is a big believer in the chicken game, which has been made easier by cheap but powerful stock-tracking tools.

He describes one strategy hedge funds use: Buy shares in an exchange-traded fund, such as iShares. These funds trade throughout the day on a stock exchange, usually the American, just like regular stocks.
The hedge funds pick a narrow sector fund that hasn't been doing much lately, like the Internet iShares this summer. A few days after buying the iShares, they buy shares in the major companies that make up the fund.

If it works, their purchases attract more buyers, which pushes up the price of the individual shares and the iShares.

"You get a double reward. And you've taken away a great deal of risk if you know you can get a pop in the iShares," Baraban says.

Patrick O'Connor, head of U.S. mutual funds with Barclays, says he's never heard of iShares' being used that way.

Baraban says he's helped hedge funds and other traders do this.

"It's a game. They can afford to play the game," he says. "This is not a market for an individual. Unless you have the ammunition, you're going to be the last person to buy into these things and the last one to sell."

Some experts doubt this game exists.

The U.S. stock market "is too big and liquid to manipulate," says AMG's Adler.

He says the rise in tech stocks "is a graphic expression of investor sentiment. It may be people are coming to a common understanding of what is going to lead the market out of recession."

Other analysts, however, say the tech revival proves we're not entering a new bull market.

"History would show that at the end of bear markets, there's new leadership," says Hickey. Because tech stocks led the last bull market, their leadership this time means we're in a bear market rally, not a new bull.

In a report this week, Merrill Lynch strategist Richard Bernstein advised investors to cut their stock holdings.

"The equity market still appears highly speculative to us. Such speculation is typically indicative of the end of a market cycle and not the beginning of a major bull market," he wrote.

He listed eight signs of speculation, including "investors seem to be ignoring the unpredictability of earnings" and "momentum is still a prime investment criterion."

He describes momentum like this: "When investors cannot explain why the market is rising or why a sector is outperforming, the standard suggestion is that the 'market is telling you something.' Stock price movements and relative strength will seem to be investors' primary concern, whereas fundamentals are a secondary consideration."

Sound familiar?