A SEARCH FOR REASONABLE VALUE AMONG STOCKS IN THE TECHNOLOGY SECTOR

FUND FACTS

FIRSTHAND TECHNOLOGY VALUE FUND—(TVFQX)

CATEGORY:
Aggressive Growth

PERFORMANCE: (thru 9/30/99)

Compound Annual Return (%)	Fund	Category
1 Year	205.1	39.5
3 Years	38.8	14.1
5 Years	48.5	17.8

RISK: (relative to category)
High

TOTAL ASSETS: (as of 9/30/99)
$500 million

CONTACT:
Firsthand Funds
888/884-2675
www.firsthandfunds.com

The technology sector continues its reign over the stock market, producing eye-popping numbers for funds that concentrate in that area. Of course, those numbers come with significant risk attached in the form of volatility.

Nonetheless, the returns are impressive. And topping both the one-year and five-year performance lists for all funds is the Firsthand Value Fund, with a 205% return over the last year and 48.5% annually over the last five years through September 30, 1999. Its risk index, not surprisingly, is high—1.6 times the risk of the average aggressive growth fund. Currently, the fund has about $500 million in total assets.

In early October, portfolio manager Kevin Landis discussed the management of the fund with Maria Crawford Scott.

What is the investment objective and philosophy of the fund?

Our objective is long-term capital appreciation—it's a technology-based fund, so obviously we are not looking for current income or anything like that.

The approach and the philosophy are dependent on our basic core philosophy as a firm. Being one of the only [mutual fund] complexes based in Silicon Valley, we think we have an inherent home-field advantage, and we try to make the most of that. As our name implies, everyone at the fund has first-hand industry experience—we all have technology industry backgrounds—so when we go to pick a technology stock, it is in a business where we've been and we understand what it takes to thrive there.

Our philosophy is that we will pick fairly important technology trends, find the best companies involved in those trends, and then we buy good companies at good prices. I think the industry term for what we do is, "buying growth at a reasonable price."

Can you buy good technology companies at good prices today?

You can buy great technology companies at good prices as long as you're willing to think for yourself and do your own homework. Basically, you need to buy the companies that aren't so obvious. It may be a well-known company that has just missed a quarter, and you know that it is a company with good products, good customers, and a growing market. Or it may be an undiscovered company that is less visible—one of the companies that is building the infrastructure of the Internet, as opposed to one of the "dot coms," for example.

In technology, if you really dig into something and understand the technology behind it, you eventually are going the find the key building blocks that put the whole structure together. Usually it is a combination of the hardware and software, and usually it involves dozens of companies, one or two that might be visible, but the rest are sort of buried. The hardware building blocks are usually little, highly-focused chip companies, and the software building blocks are specialized software companies that do a certain function very, very well. These companies' products are usually embedded and hidden behind enough layers that most people don't even see.

How do you value a stock to determine whether it is undervalued?

That is a conundrum for a lot of investors, because you need to respect the financial data, and the hard data is all historical. Now, it is important to know where a company has been, but what really has value is a company's

future. What we do is to run financial models on companies until we get an understanding of what we think that company is capable of delivering in the future, maybe 18 months from now or maybe in three years. We look at the earnings per share the company is likely to produce down the road, or at least an amount we think we can reasonably anticipate. And then we ask ourselves: What is a reasonable multiple to pay on that? To determine that, we'll take a look at the price-earnings multiple for the peer group and what the market typically pays for companies like that.

Your earnings projections are obviously very important. What goes into that equation?

First and foremost are the products—you have to anticipate the success of the company's products and the future products that are likely to be good ones. From that, you start out with a projection for top-line growth—it's rare that you'll see an exciting young growing technology company that doesn't have great top-line growth.

Then you have to ask yourself whether they are likely to do a good job of running their business. If they currently have gross margins that are 35% and they tell you that their target is 45%, you have to ask yourself whether you think they are capable of doing that and over what period of time.

Then you build an income statement on them and, of course, make sure the balance sheet looks good as well. For a growth company, you don't have to "bulls-eye" next year's balance sheet, but you have to keep an eye on it and make sure it's not a problem.

Do you place much emphasis on research and development spending?

What you're betting on is a company's ability to generate great new products for their customers and that has to come from somewhere. But I hesitate to say that it's a direct result of the money they spend on R&D because I've seen so many examples where that is not the case.

First of all, you can't throw money at a problem. Sometimes two or three very talented people will come up with things that staffs of 20 couldn't. If you want a great example of that, look at Cisco Systems. They will go out and buy young companies with better products even though they have plenty of money to spend on the R&D themselves.

Your fund concentrates a lot on certain technology sectors. How do you pick those sectors?

What we do is take a look at a very powerful trend. For example, I might say that a powerful trend in the next 10 years is wireless technology. Then we'll dig into that trend. We'll figure out who the big players are, and wireless is a good example because the obvious ones are the established, large-cap players: Ericsson, Nokia, Motorola, and increasingly, Qualcomm. But those are just on the surface. You have to do your homework and see what's beneath the surface. And you'll find that there are many companies involved in combining a lot of different technologies to make it all work. If you understand how all the companies relate to each other, you can usually find something that is a little less obvious and a little more of an opportunity for you—more likely to be underpriced or undiscovered.

For instance, in wireless, we invested pretty heavily in a chip company called TriQuint Semiconductor. They make some of the components that go into the cell phones, so even though your cell phone might say Motorola or Qualcomm or Samsung, when you break it open, you'll find out it has a TriQuint chip in there, along with several other chips. That's a good example of a company that is involved in the process, but that was valued very attractively six months ago just because it wasn't well-known.

One of your reports said AT&T is the only telecommunications sector holding that you have in the value fund. Why AT&T, and not any of the other companies?

AT&T is in a position to be a great company, but right now they are not valued that way. If you look at the valuation for WorldCom or Qwest, the industry will clearly pay up and put a fairly aggressive valuation on a telecommunications company that is "on the move"—making the right moves and doing the right things. AT&T is viewed more as a sleepy giant, but I think they're not so sleepy any more—I think they are wide-awake and making some of the right moves, getting into cable, that kind of thing. They understand what they need to do to take advantage of their position. Three or four years ago, if you bought IBM, people would be giving you the same kind of look. But IBM had figured it out—they made some good decisions that let them take advantage of their situation. I think AT&T can make that same kind of turnaround.

The other telecommunications firms don't make it through our rigorous screen of being great companies at great prices for the Value Fund.

Many technology funds currently have focused on the large-cap companies, but the Value Fund invests in many different sizes. Why do you focus less on the large caps?

First of all, we do have a fund that invests in the leading technology funds—our Leaders Fund.

The Value Fund has a different purpose. We've stayed away from a lot of the darlings—we've stayed away from the "dot coms," and we've stayed away from the big caps. We think that there are a lot of companies to choose from. If you hunt around, you'll find some great opportunities and you don't need to go after the obvious

names, even during a period of time when the obvious names are doing well. You don't need to take that risk.

What about Internet stocks?

When people see our numbers—50% annual return for five years—they automatically assume they are Internet-driven, but there has never been a dot-com stock in the fund. The valuations are just too high, and the companies are too obvious. I think it is safer for us to recognize that regardless of where people go on the Net, they are going to travel around a lot, and therefore, we are going to bet on Internet traffic and invest in the companies that will make that happen.

For instance, one of our biggest holdings is a company called PMC-Sierra. It looks like it is a chip company, and it's categorized as a semiconductor company. But every chip they make is involved in moving information. PMC's biggest customer is Cisco, and in addition to selling to them, they sell to 3Com, Lucent, Newbridge, and Ericsson—all telecommunications or networking companies. They, in turn, sell to the WorldComs and AT&Ts of the world who carry all that Internet traffic. So when eBay booms, it stimulates traffic, which stimulates networks to buy more networking equipment, which, if you open it up, has little building block chips from companies like PMC-Sierra. Wall Street started out valuing them like regular semiconductor stocks. Now they've finally figured out that PMC is really a communications stock, and it's just that the package it comes in is a chip. That is our approach.

You also tend to invest heavily in only a small number of stocks—why?

There is a dogmatic conventional wisdom that says that diversification is safety. But I wonder whether people are comfortable having their money invested in my 60th or 70th best idea, particularly in a technology fund, where I am assuming it is not the shareholder's only investment. In a technology mutual fund, I don't think it is a good trade-off to try to add too much diversification because I am assuming that our investors add their own layer of diversification themselves, and what I should be doing is really concentrating on my best ideas.

What would cause you to sell a stock?

Well, there is the happy case in which you are correct about a stock, and it takes off and becomes at some point so richly valued that you are not comfortable holding it anymore. That happens every now and again.

Then there are the deteriorating fundamentals scenarios. There are actually two different versions of this. One is you made a mistake, and the fundamentals fell apart because you bought the wrong company. Two is you actually made a good decision, but while you were waiting for the rest of the market to come to its senses and recognize this company for the great company that you knew it was, something changes—something bad happens to the company, or Microsoft decides to get into their market, or something sufficiently scary like that. In that case, you then just have to swallow hard and get out.

When you make mistakes, where do those usually crop up?

Technology is about making new things possible, so you've got new markets that open up and you've got a lot of different companies in a race to try to come up with the best new solutions. Sometimes it's the market that just doesn't ever show up, even though you've got the company with the better, but unwanted, mousetrap. And sometimes it's the company that doesn't perform—you are in the right market, on the right trend, and you bought the cheaper of the two companies you were considering, and guess what? It was cheaper for a reason.

What are the big trends or themes you are focusing on in the fund right now?

Internet traffic is going to continue to grow, so companies that help build the infrastructure that carries that traffic will do very well. In addition, wireless is going to be very, very big. Wireless communication is not just about Internet traffic, but also voice traffic and all kinds productivity. Most people on the planet have never made or received a telephone call. When that basic level of service comes to them, it will probably be with wireless technology because it is so flexible and a practical way to go, instead of stringing up wires.

We're also invested around the emergence of DVD players and around flat panel displays. That monitor there [pointing to a PC monitor] is a dinosaur. In five years, you won't have a monitor there, you'll have a flat screen—it will be a nicer display, easier on your eyes, and you'll love it. And you'll be appalled that you ever used a big clunky monitor.

The E-commerce trend is big too. There are a lot of companies that are rushing to embrace that sort of E-business model and they know they need help, and there is room for a lot of high tech companies to benefit from that. So, I'm not going to try to pick the non-technology companies benefiting from E-commerce on the Net, but what I will try to do is figure out which technology companies are going to help the winner beat the loser to the punch. ✦