A BROAD-BASED APPROACH TO INVESTING IN TECHNOLOGY LEADERS

FUND FACTS

INVESCO STRATEGIC PORT.—TECHNOLOGY (FTCHX)

CATEGORY:
Aggressive Growth

PERFORMANCE: (thru 6/30/99)

Compound Annual Return (%)	Fund	Category
1 Year	50.1	16.3
3 Years	28.3	15.9
5 Years	30.9	20.5

RISK: (relative to category)
High

TOTAL ASSETS: (as of7/30/99)
$2 billion

CONTACT:
INVESCO Funds
800/525-8085
www.invesco.com

Technology stocks continue to dominate the market and attract strong investor interest. And mutual funds that focus on technology have proliferated in size and number.

One broad-based technology fund that has done relatively well over the long-term is the INVESCO Strategic Portfolios—Technology. During the first half of the year, the fund was up 33.5% compared to 14.3% for the average aggressive growth fund, and it was among the top 20% of all aggressive growth funds for the last year, three years, and five years (through June 30). The fund currently has $2 billion in total assets.

In early August, portfolio manager William R. Keithler, who took over management of the fund at the beginning of the year, discussed his investment approach with Maria Crawford Scott.

What do you consider to be a "technology" company?

Well, it's fairly broadly defined—anywhere from telecommunications equipment and services; computer-related products such as hardware, software, peripheral devices, semiconductors, and semiconductor capital equipment; service-related companies that provide various information technology; and applied technology companies that take a technology and market it in specific vertical applications. It also includes a modest exposure to biotechnology, but the focus is really more information technology related.

What is the approach you use in building your portfolio?

We really try to focus on companies that are leaders in their sector of technology. Just to give you an example, Cisco Systems is one of our larger holdings and they are clearly the leader in local area networking, and they are trying to expand into wide-area networking, and being reasonably successful at that. Microsoft clearly dominates desktop applications and operating systems. Nokia, which is a manufacturer of telecommunications equipment for the wireless industry as well as handsets, is the market leader in that area.

What do you look for in terms of market leaders?

Market share is certainly important, as is market growth—those are the two biggies. When we are looking at a company in an emerging market that hasn't really sorted out yet and there are a number of contenders, we'll often take a basket approach and own several companies until it becomes more apparent who's going to win the race.

One other thing I should point out is that we have a core strategy that accounts for anywhere from 50% to 80% of the portfolio—that is where we focus on the clear market leaders. Then we have a more tactical portion of the portfolio, where we take advantage of broad trends and where we will dip a little bit down beyond the market leaders.

For instance, the semiconductor industry right now is in the midst of a very broad-based and, we believe, extended cycle that is enabling us to take advantage of that and own a more commodity-oriented company. Typically, we like to focus on companies that have a proprietary product that are more or less in control of their own destiny, as opposed to having a product that is easily substitutable—more commodity-oriented. But there are times when the commodity producers are a good place to be, and in the semiconductor area that has worked out quite well for us.

In a situation where we see one sector having very strong fundamentals, we'll dramatically overweight that sector and we'll find more and more companies that we believe have the type of earnings growth that can support a higher stock price. Those are more tactical calls, as opposed to strategic calls. Now, we're almost always going to have exposure to semiconductors, or software, or telecom equipment, but depending on the relative attraction of the stocks, we'll broaden our exposure beneath the market leaders when we think there are investment opportunities, as we see in semiconductors right now.

Are there any sectors that you totally avoid?

Until recently, we haven't owned anything in the personal computer area. We've owned Apple now for three or four months, and that is working out well, but they are a special case. The industry is really dominated by Microsoft Windows software and Intel hardware, and companies like Compaq, Dell, Gateway, etc. are all basically cranking out the same product. For these companies, it is really a distribution and marketing game more than a technology game. Apple is unique in that they run their own operating system, and not an Intel-based architecture.

How do you value technology stocks?

We look at fairly traditional measures—price-to-sales, price-to-earnings—and we look at them relative to the market, relative to competition, and relative to where they have traded in the past. But it is a tool not a methodology—it gives us some sense of what the level of risk is and what the level of opportunity is.

And I assume a lot of it is based on your own earnings projections?

Absolutely—we are definitely earnings growth driven. Now, I don't want to give the impression that we are momentum investors because we are not, we are very fundamentally driven. But at the same time, we're very interested in rapidly growing companies and the fund is fairly aggressively postured with respect to that.

As for earnings projections, we use the Street [Wall Street analysts' estimates] to gauge where the consensus is, and then we make our own judgments. Often, there's not much variance, but other times there is, and that either indicates to us that there is risk in the stock because the Street is being too aggressive, or there is opportunity because we think the Street is missing something.

There is a lot of gaming that occurs both among analysts and with companies, because it is not a matter of meeting the numbers [earnings estimates], it is a matter of beating them. And it is not even a matter of beating published numbers but beating the whispered numbers. The whole thing is a bit of a joke. For instance, you'll have an analyst say in his written report: "I think Lucent is going to earn $0.20 this quarter," but he'll also say verbally, "I really think they are going to do $0.21–$0.22." He never publishes that number, but it gets around, and that's really what runs stocks up ahead of earnings reports and causes so much volatility, especially if Lucent reports $0.20—the posted number—and everybody's disappointed.

What would cause you to sell a stock?

We have a three-legged stool on which we try to rest our investment confidences.

One, in terms of fundamentals, we are looking for companies that are market leaders. We like to see very strong management teams who've executed in the past and in whom we have a high degree of confidence. We like to have a business model that makes sense and we believe is sustainable. We like them to be operating in a market that is large and preferably growing. And as I mentioned, we like to have a company in which their product has some degree of propriety and some degree of customer lock-in that enables them to maintain their competitive position.

Second, we use valuations as a tool to gauge the level of risk in the stock and to gauge the potential upside. We wouldn't sell a stock simply because it is, in our analysis, expensive although we may reduce our exposure somewhat. The whole issue of balancing the portfolio from a risk/reward standpoint is a little bit art and a little bit science, but we try to take a 'weight of the evidence' approach.

Third, for technical analysis, we use an early-warning system for stocks we hold and a reality check for stocks we are considering buying.

If a stock checks out fundamentally and the valuations are OK but the technicals are weak or negative, we try to determine why—what problem is the market having with this story, and what are we missing? Sometimes it is something fairly innocuous, maybe a large stockholder changed managers and they are liquidating the holdings because of style reasons or some similar reason. Then it is the proverbial buying opportunity.

Other times, the warning sign could be a harbinger of some change on the horizon that we hadn't considered or hadn't noticed—maybe a competitive technology or a big player entering the market, demand growth slowing, or some other fundamental factor. Often, that kind of thing will show up in the stock price before you hear about it from an analyst, and so it is a kick in the rear-end, so to speak, for us to get out there and figure out what is going on.

What kinds of things constitute a warning signal—a price drop?

Well, not necessarily. Really it would be a divergence in price performance from what you would expect to see relative to other companies in its sector, the industry and the market overall. If a stock begins a serious technical breakdown, I've found that that's a better sell signal than an expensive valuation.

So you are looking at things like relative strength measures?

Among other things, yes.

Generally speaking, if a stock has risen to where it is a significant position in the portfolio and the valuation is high, that's one level of risk. If the market in which the company is operating has become very competitive, that is another level of risk. If we see a management departure, no matter how well explained, that is another level of risk. If there is insider selling, no matter how well rationalized, that is another level of risk. The more we get these little incidents that are indicative of risk, other things being equal, the more I'll be inclined to reduce my exposure to a given stock.

Obviously, the worst case is where we were dead wrong—the company doesn't execute, the market doesn't develop, and the company fails to achieve the sort of earnings growth that we had expected. Then we sell the stock.

What about the Internet stocks?

We are a believer in the significance of the Internet as a medium that is every bit as revolutionary, I think, as radio and television were in their day and possibly more so. However, the stocks themselves are going to be difficult performers. They are extremely volatile. Their price is often driven by non-fundamental investors, which is to say day-traders who don't really know fundamentals. They trade on rumors and they certainly are not valuation-sensitive.

It is an industry that is still very nascent and it is very difficult to project who is likely to be a winner. Yahoo is probably going to dominate the portal space for some time to come, but things change very, very rapidly. And this year, with the IPO market having gone as crazy as it has, there has been such an influx of companies that have come public with really little more than a business plan on the back of a napkin—not a lot of experience, not a lot of depth of thinking, not a lot of depth of management, and a lot of risk.

I think it is ludicrous, and while there already has been a shake out, I think there will be a much more violent one over the next few years as a lot of these companies prove to be not equal to the task.

We've been focused more on companies that supply infrastructure to either companies that are directly focused on the Internet or corporate companies that are seeking to Web-enable their businesses. We see that as a big driver.

For instance, Inktomi is a company we've owned for a while. This is a company that has multiple revenue streams. Among other things, they have a search engine technology that they sell to numerous companies either in the search engine business or that want to insert that capability on their Web page. Their model is such that every time somebody searches the cash register rings for Inktomi—they get paid a little bit. So they not only sell their product to but they are also able to garner revenues based on the growth of the industry and the success of these companies.

How is the Y2K problem going to affect technology stocks?

I'm going to be really glad when 2000 is behind us. I suspect there is going to be an impact in companies' fourth quarter level of business, and we may see that show up as soon as the September/October reporting period when my companies become aware that part of the reason their business has been so strong has been that people have been building up stockpiles for the fourth quarter of this year and the first quarter of next year, and they are going to stop buying or they are going to drastically curtail their spending.

It is by definition a one-time issue. However, it could create a situation where there is uncertainty, and the market doesn't like uncertainty. It's hard to predict.

I think chances are pretty good that we will see some degree of dislocation and some degree of selling later this year. But we try to take a longer-term point of view. We are planning on being in business next year, and I think the fundamentals for the technology group overall remain very strong. If the market sells the stocks off and stocks go on sale, we typically try to take advantage of that and upgrade the quality of the portfolio.

What about risk? Relative to other technology funds, your fund in the past has had relatively low stock market risk, although of course it is higher than the average stock fund.

It is probably going to be somewhat higher in the future, because I tend to be a more aggressive manager than the prior manager.

My fundamental belief with respect to technology is that it is probably the most exciting area of the economy in terms of change, creating wealth, and really changing the world. If you look over the last 10 to 15 years, the number of companies that have been started and that have become extremely significant companies in the market are primarily in technology—companies like America Online, Cisco Systems, even Microsoft, which is a little older—these are enormous companies.

One of the attractions to technology investing is the potential for explosive earnings growth, and that is really what we are trying to capture in this fund. It is an aggressive portfolio, but we believe that we'll realize the reward for taking that risk, and the opportunity is certainly there given the growth potential in the industry. ✦