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Do Tech Stocks Have Much Further to Fall?

Several Websites weigh in on Netflix and other battered technology names. And is there value in junk bonds?

By JOHN KIMELMAN
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Over the last month, the Standard & Poor's 500 index is off by about 2%. But the PowerShares QQQ Trust, a proxy for the Nasdaq 100 index, has fallen by about triple that level.

And some of the big glamour tech names, such as videostreaming service Netflix (ticker: NFLX), Facebook (FB) and Twitter (TWTR), have each lost at least 20 percentage points in that period.

The problem is that some publications make a compelling case why many of these stocks still have further to fall.

Writing for Fortune, Senior Editor Stephen Gandel argues that many leading tech stocks simply aren't generating the kind of double-digit earnings growth they are famous for -- the kind that helped them justify their double-digit price-to-earnings multiples.

Fortune

The Problem With Tech Stocks

" Microsoft (MSFT), for instance, is only expected to increase its earnings 3.4% this year. Income at Oracle (ORCL) is projected to rise 1.3%. Even with Apple (AAPL), analysts are only looking for a 2.8%

bottom-line jump," writes Gandel. "Back in 2001, analysts were predicting that the companies that then made up the Nasdaq 100 would boost their bottom lines by 34% over the following year. These days, analysts are projecting a more modest 10% growth in earnings among Nasdaq's 100 largest companies."

Gandel writes that investors who bought into technology stocks in early 2001, almost a year after they had been falling out of a belief they were picking up a bargain, didn't get one. "The Nasdaq 100 fell another 33% that year," he writes. "Today's technology investors could be similarly disappointed."

Given that most tech stocks haven't fallen nearly that much, Gandel's point might be even stronger today.

Meanwhile, David Trainer, a managing partner with Novo Capital Management, a Brentwood, Tenn.-based fund shop, argues that "exploding content costs" will continue to put pressure on Netflix's troubled shares.

He argues that the stock is worth shorting even after losing a quarter of its value in the past month.

Sum Zero

The Case Against Netflix

"In 2009, Netflix earned [after-tax profits] of $119 million so over the past five years NFLX has grown after-tax profits by just $29 million, or 4% compounded annually," Trainer writes. "This slow profit growth is largely due to two factors: rapidly rising content costs and the decline of Netflix's high-margin DVD rental service."

Judging by Netflix's 2013 annual report, Trainer writes, "it does not look like either of these trends will reverse in the future."

Trainer adds that last November, "we predicted that Netflix's bottom line would find itself in trouble as costs rise because creating original content and hosting a content library are extremely expensive. Netflix is merely a delivery platform, hardly unique anymore. The company has many competitors now, many of whom are much better competitively positioned. For example, Amazon is currently considering launching a streaming television and music service in the same vein."

Trainer points out that much of the Netflix bull case rests on the opportunity for international expansion. "It is true that Netflix's international subscriber base grew by an impressive 79%, and it is also true that there is presently much room for growth here," he adds. "However, the same cost and pitfalls I have described above are not exclusive to Netflix's U.S. operations, and additional hidden costs exist in expanding to international markets"

Trainer concludes by noting that in the past six months, insiders have sold off over one million shares, or 45% of their holdings. "If this level of dumping does not serve as a warning to investors, I am not sure what will," he concludes.

For risk-taking investors leery of tech stocks, even after their recent fall, there are always junk bonds.

As the Financial Times puts it, "Lured by the higher returns and low corporate default rates, investors have lined up in scores to buy record amounts of the securities, which in turn have been sold at increasingly higher prices and with looser standards of protection for the lenders." (A subscription is required.)

Financial Times

Is There Still Value in Junk Bonds?

The problem is that the junk market has now reached a lofty level in terms of valuation, "raising concern of an asset bubble in some quarters, but some fund managers and analysts say there is still more to be mined, so long as investors know where to look."

The FT makes a few suggestions that are worth considering.

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