Investing in Tech Stocks: What You Need to Know

Description

During years of rampant speculation leading up to the dot-com bubble in the late ’90s and 2000-2001, many technology stocks belonged to risky companies unable to turn a profit. Today, however, the tech sector includes companies across the whole spectrum of financial and operational health, from those still striving to become profitable to established cash cows like **Apple** and **Facebook**.

Sure, tech stocks are still more volatile than those in more established sectors like utilities and consumer goods, but as long as investors are willing to embrace more volatility, there are some stellar businesses — and potentially highly rewarding stocks — to invest in.

The sector, therefore, is worth exploring in detail. By fully understanding what the tech sector entails, including its opportunities and threats, the type of stocks that it includes, how to value a tech stock, and more, investors will be well positioned to identify and invest in the industry’s most promising stocks.

What are tech stocks?

Tech stocks are the publicly traded shares of companies engaged in selling technology-based services or products. In other words, they represent shares of ownership in technology companies available to buy or sell on the stock market.

Stocks in this sector range from those in older technology industries, such as telecommunications and personal computers, to those in more nascent segments, such as software-based internet services and online social networks.

Their business models vary substantially as well. Some companies manufacture technological equipment, such as routers and computer processors. Others design products but outsource manufacturing. Furthermore, modern organizations have adopted creative ways of selling technology services, including offering subscriptions to cloud-based applications, providing access to online networks in exchange for ad-supported experiences, charging fees for online transactions facilitated through online marketplaces, and more.

What types of companies are in the tech sector?

There are many ways to break down the tech sector, but perhaps the most useful way for investors to look at the market is through the lens of four types of businesses: software, hardware, internet information, and telecommunication.

1. Software companies

These companies make money from selling the programs used by computers. Historically, software was often sold on an Ã la carte basis. More recently, however, customers are increasingly paying for subscription access to software made available over the internet. This business model is often referred to as software-as-a-service, or SaaS.

2. Hardware companies

These companies sell both components for technology products and the finished technology products themselves. Examples include semiconductors, servers, computers, smartphones, consumer electronics, computer peripherals, and data storage devices.

3. Internet information companies

These companies make money from providing content, networks, and marketplaces on the internet. **Yelp**, for instance, provides both a platform for connecting users with local businesses and information about those businesses. **eBay**, for another example, provides an online marketplace for users to buy and sell goods on the internet.

4. Telecommunication companies

This industry includes companies that enable communication, primarily through telephone, data, and video. But companies that connect the world through satellite, radio, television broadcasting, and internet usually fall into this category as well.

10 types of tech stocks to consider investing in

Looking beyond this 10,000-foot view of the tech sector, investors who want to buy stocks in this space should be familiar with some of the biggest trends in tech stocks. The following 10 tech trends provide investors with themes to look for as they decide what companies they want to invest in.

1. SaaS

Software-as-a-service (SaaS) companies charge customers a subscription or a usage-based fee in exchange for providing access to cloud-based software applications. Many SaaS companies provide software for enterprises, including sales, customer relationship management, inventory management, accounting, and workplace collaboration platforms.

2. Fintech

Financial technology companies provide software-based solutions for various financial services. Some examples include mobile banking, digital payments, peer-to-peer mobile payments, and online budgeting and accounting software. Fintech companies often operate with SaaS business models or take a cut of the transactions made on their platforms.

3. Social networking

Social media give users access to an online network for connecting friends, family, groups, colleagues, and organizations. Facebook, of course, is the perfect example of a social networking company. Monetization models for social networks vary, but primary approaches include digital advertising, subscriptions, and a hybrid of these two.

4. Internet of Things

The Internet of Things (IoT) refers to internet-connected and software-powered devices. Thanks to technology and continuous improvements in high-speed wireless internet, once-ordinary products such as refrigerators, garage door openers, and healthcare devices now have enhanced capabilities and can be controlled through software via the internet. Internet of Things companies sell these connected devices and sometimes provide software services to assist them.

5. Artificial intelligence

The convergence of the ability to store massive amounts of data, the continuing evolution of deep learning algorithms, and advancements in graphics processing unit (GPU) computing have brought about an era of artificial intelligence (AI). AI technologies and services can learn, adapt, improve, and act on their own. Examples include voice assistants, self-driving car technology, customer service chatbots, and more. The most relevant companies in this space are the semiconductor companies involved in building the computing power for the evolution of AI. However, AI is quickly finding its way into many different fields, including transportation, risk management, investing, and more.

6. E-commerce

E-commerce refers to selling physical and digital goods and services online. The most direct beneficiaries of e-commerce trends are online retailers, online marketplaces that enable other businesses to sell their products, and companies that provide platforms for businesses to build their own online shopping experiences for their customers.

7. Connected TV

Connected TV refers to television streamed over the internet. This space is fast growing because consumers are shifting more of their viewing time to streaming TV as content publishers and advertisers respond to this trend. While **Netflix** is the most obvious example of a company benefiting from connected TV, many companies have flocked to the space with a wide array of business models.

8. Digital advertising

One of the ways businesses are profiting from connected TV is through digital advertising, or advertising online. It stands to reason that advertisers ultimately want to spend their dollars where the consumer is. Growing smartphone usage, combined with consumer adoption of streaming TV, video, and music services, means that marketers are ramping up their spending on digital ads. Some of the biggest beneficiaries in this market are companies with platforms that help marketers buy and sell ads digitally. However, content publishers also benefit from the revenue produced by ads that run in their content.

9. Cloud computing

Cloud computing refers to the delivery of computing services over the internet. These services come in many forms, including off-premise servers, storage, databases, and networks that can be accessed through the internet. The value proposition for cloud computing companies is that businesses can pay for their usage only, helping organizations never over- or underinvest in their computing capacity.

10. Semiconductors

Semiconductor companies are involved in different aspects of manufacturing, designing, and selling computer processors, such as central processing units (CPUs) and graphics processing units (GPUs).

Tech sector tailwinds

Two key tailwinds in the tech sector are organizations' digital transformations and the adoption of e-commerce across sectors.

1. Digital transformations

Companies across all sectors are embracing technology in one aspect or another to better their businesses. Cloud computing, AI, and cloud-based software platforms are enabling organizations to improve everything from streamlining back-end operations to making better connections with customers. This embracing of technology across organizations is referred to as companies' " digital transformations."

A wave of nontech companies undergoing these digital transformations is benefiting many tech companies. This is helping supplement demand for cybersecurity, business software, data and analytics, fintech, cloud computing, and AI solutions.

2. Adoption of e-commerce

E-commerce remains a major tailwind for many technology stocks. Companies in essentially every sector are embracing e-commerce in one form or another. For instance, airlines are selling tickets on their websites and on third-party travel-booking platforms; brick-and-mortar retailers are implementing digital strategies; and restaurants are rolling out online loyalty programs and delivering food through third-party food-delivery apps.

Some of the tech industries directly or indirectly benefiting from the rise of e-commerce include fintech, business software, cloud computing, and even digital advertising companies.

Tech sector headwinds

Two key headwinds for tech stocks are high employee turnover and lower barriers to entry.

1. High employee turnover in software

According to 2018 data from LinkedIn, employee turnover in tech (software in particular) is higher than in any other industry. The turnover rate in software-related jobs is 13.2%, according to LinkedIn. Turnover rates at jobs in other major industries include 11.4% in media and entertainment and 10.8% in both financial services and telecommunications.

The problem? High demand for tech workers and rising competition within the industry, says LinkedIn's Paul Petrone:

> [A]s employers and offers get more competitive, top talent is more eager to jump on new opportunities. The numbers support this theory — according to LinkedIn data, almost half (49%) of departing tech employees take another job within the tech sector.

While employee turnover itself can lead to issues in building and maintaining a stable team, a greater underlying problem that the competitive environment for tech employees creates is the need for organizations to offer attractive compensation packages, often including stock-based compensation on top of regular salaries. As a result, meaningful stock-based compensation has become a regular business expense at companies like **Alphabet** and Facebook. For some companies, this can result in significant shareholder dilution over time as the number of total shares increases as a byproduct of share-based compensation.

2. Lower barriers to entry

Capital-intensive industries, such as the auto business, airlines, and railroads, often require significant up-front investment in factories, machinery, and real estate in order to enter the market successfully.

This gives incumbents somewhat of a competitive edge, as there are high barriers to entry for new entrants.

On the contrary, for many technology companies — particularly software providers and internet information providers — start-ups can morph into significant competition for incumbents in a very short period of time, and often with a surprisingly small amount of capital. Barriers to entry in some technology industries, therefore, are low.

On a similar note, this means large and well-capitalized technology giants such as Apple, Alphabet, and **Microsoft** can easily deploy new software-based services that could threaten smaller technology companies.

Analyzing tech stocks: Key metrics and characteristics to look for

While there are things that are particularly important to look for when analyzing tech stocks, the same fundamentals used for investing in any stock are still applicable. For instance, investors should ensure that a tech stock they are interested in has:

- A competitive advantage, such as proprietary technology, high switching costs, or a powerful brand
- A solid balance sheet, including manageable debt levels and ample cash to weather a challenging season
- A reasonable valuation (even a great company could be a bad investment if the stock is bought at a price that doesn't make sense)

Beyond these fundamentals, other metrics and characteristics that are particularly important for tech stocks include gross profit margin, operational leverage, a broad customer base, and revenue growth. Here's a look at how investors can check out these factors when analyzing a tech stock.

1. Gross profit margin

Because the business models in tech vary so greatly across industries (and even within industries), one company may make a significantly different amount of gross profit (revenue minus the direct costs of producing a good or service) on their offerings than others. To put a company's gross profit into perspective, divide gross profit by revenue to get a metric called gross profit margin.

Gross profit margin gives investors insight into the economics of a company's business. The higher the gross profit margin, the more lucrative the company's business model is, as long as it can maintain low operating expenses (incurred expenses that are not directly associated with the goods or services a company sells, such as sales, marketing, and administrative costs). The best technology companies often have gross profit margins that are superior to peers in the same industry.

2. Operational leverage

While many tech companies — especially software providers — have high gross profit margins, a large

portion of their spending may fall under operating expenses. If operating expenses do represent a large portion of revenue compared to peers, investors should look for evidence of operating leverage.

Operating leverage is present when a company's revenue grows at a faster rate than its operating expenses. This leverage from outsize revenue growth means that, over time, more of the company's revenue will fall to the bottom line, or its net profit after all expenses. When a technology company has operating leverage, the company's business model is considered scalable. In other words, the business's economics improve as revenue increases.

Operating leverage is particularly important when a technology company is not yet profitable on its bottom line. With the help of operating leverage, an unprofitable tech company has a clear path to profitability, as long as revenue can keep growing.

3. A broad customer base

Investors should look at a tech company's customer base. Some tech companies — such as hardware providers (particularly semiconductor companies or manufacturers of electronic parts) or companies providing software to businesses — may be highly reliant on a few large customers for a significant portion of their revenue. If the loss of a single customer can have a material impact on the company's business, then it is a risk for shareholders. Investors, therefore, should ensure that business-facing technology companies have an extensive portfolio of clients.

4. Revenue growth

Another key metric often used when analyzing tech stocks is revenue growth. Because many tech stocks are in high-growth industries, quarterly year-over-year revenue growth rates are often closely watched by Wall Street.

Investors can often get an idea of a company's momentum by looking at its trends of revenue growth rates over multiple quarters. For instance, when year-over-year growth rates are higher in one quarter than they were in the previous quarter, the company is seeing accelerating growth. Conversely, a lower growth rate in the current quarter compared to the previous one means the company is seeing decelerating growth.

An accelerating growth rate is often indicative of a strong tailwind or catalyst for the business. When investors see this trend, they may want to do more research to see what is behind this momentum. On the other hand, decelerating growth rates could suggest a tailwind or catalyst is losing its luster; while decelerating growth is not always bad, investors should be aware of why growth is slowing down.

Valuing a tech stock

For the most part, investors should approach valuing tech stocks in the same manner they would value any stock. A price-to-earnings ratio, or the ratio of a company's share price to its earnings per share, can give investors an idea of how the stock is priced relative to its underlying profit. Similarly, a price-to-book ratio, or the ratio of a stock's price to its book value per share (assets minus liabilities divided by shares outstanding), helps investors understand the premium a company's stock price commands

relative to its underlying book value. Investors can look at these common valuation metrics for a given company and see how they compare to its industry peers.

But there is one metric that may be particularly useful when valuing tech stocks: price-to-sales, or the ratio of a company's market capitalization (shares outstanding multiplied by share price) to its total sales. This metric helps investors view the premium at which a company trades relative to its sales. A high price-to-sales ratio relative to peers usually suggests that investors think sales will grow faster than its peers' will. A lower price-to-sales ratio, therefore, is usually evidence that the market believes a company's sales will grow slower than its peers'.

While the price-to-sales ratio is far from perfect, it's useful when comparing members of an industry to one another. For instance, an investor can compare a given company's price-to-sales ratio to the average price-to-sales ratio of stocks in that industry.

A price-to-sales ratio is especially useful for many tech stocks because tech stocks within the same industry can be at dramatically different stages of profitability due to the high operating leverage some tech stocks have. For example, an upstart in fintech with $200 million in revenue is likely not yet profitable. Meanwhile, a more established fintech company with $15 billion of annual revenue may be bringing in $2 billion of profit every year because it has scaled its business enough to achieve meaningful profits. In this case, comparing the two stocks' price-to-earnings ratios would not help. Looking at their price-to-sales ratios, however, could prove to be more useful when trying to understand how the market has priced these stocks relative to their underlying businesses.

Opportunities for tech stocks

Two of the biggest opportunities for many tech stocks are the subscription economy and the integration of technologies into new business models.

1. The subscription economy

An interesting opportunity in tech is what is being referred to as the "subscription economy." Zuora, a company that is at the heart of this trend as a provider of technology that enables companies to transition to subscription-based business models, defines the subscription economy as "the idea that customers are happier subscribing to the outcomes they want, when they want them, rather than purchasing a product with the burden of ownership."

Technological advancements are making it easier than ever for businesses to offer customers subscription options to get access to both digital and physical goods.

2. The integration of technologies

Many new technology companies exist due to the careful integration and combination of a handful of key technologies. As software becomes more powerful (thanks to innovation and iteration in computing and programming and faster wireless data transfer speeds), there are always new ways to implement software to solve problems or create new opportunities. For instance, for the ride-sharing industry to exist, it required wireless internet, mobile payment, global positioning systems (GPS), smartphones,

and mapping software.

As new and existing technology companies find more ways to combine various technologies, they will be able to improve current offerings and launch entirely new ones.

Risks for tech stocks

Two of the biggest risks for tech companies are regulatory scrutiny and overseas manufacturing.

1. Regulatory scrutiny

Recently, regulatory scrutiny among tech stocks has been a headwind for the sector. Data and privacy, in particular, have been seeing more scrutiny from regulators. This scrutiny could present challenges for many technology companies, considering how critical the transfer and use of customer data is to many of their business models.

2. Overseas manufacturing

Many tech companies produce products or source parts outside the U.S. to save money on labor costs. Not only does this make these companies more reliant on a country with different laws and business practices, but it could be a risk if the U.S. government's trade relations with that country deteriorate. For example, recent U.S.-China trade tensions have put pressure on some hardware technology companies that are reliant on parts from China to find ways to manufacture or buy these parts in the United States.

The 10 largest players in tech

With all of this background on the tech sector and tech stocks in mind, let's look at some examples of major tech companies. Here are the 10 largest American tech stocks based on market cap, as of September 2019:

Company	Market Capitalization	Revenue (TTM)	Net Income (TTM)
1. **Microsoft** (NASDAQ: MSFT)	$1.07 trillion	$125.8 billion	$39.2 billion
2. **Apple** (NASDAQ: AAPL)	$964 billion	$259.0 billion	$55.7 billion
3. **Amazon.com** (NASDAQ: AMZN)	$911 billion	$252.1 billion	$12.1 billion
4. **Alphabet** (NASDAQ: GOOG) (NASDAQ: GOOGL)	$841 billion	$148.3 billion	$34.7 billion
5. **Facebook** (NASDAQ: FB)	$545 billion	$62.6 billion	$17.1 billion
6. **AT&T** (NYSE: T)	$262 billion	$183.5 billion	$17.4 billion
7. **Verizon Communications** (NYSE: VZ)	$242 billion	$131.1 billion	$16.4 billion
8. **Intel** (NASDAQ: INTC)	$222 billion	$70.4 billion	$19.7 billion
9. **Cisco Systems** (NASDAQ: CSCO)	$207 billion	$51.3 billion	$13.2 billion

Company	Market Capitalization	Revenue (TTM)	Net Income (TTM)
10. **Oracle** (NYSE: ORCL)	$180 billion	$39.5 billion	$11.1 billion

Data source: Morningstar. Market caps as of Sept. 5, 2019. TTM = trailing 12 months.

These stocks will likely be volatile. After all, tech stocks generally see more volatility than stocks in other industries. In addition, they could fall sharply during recessions or broader market sell-offs. But as a group, these stocks will likely appreciate in value over the next five years or more.

Ready to invest?

As this overview of the tech sector makes clear, the space is home to many exciting companies with powerful tailwinds at their backs. But there are clear risks and concerns for investors to consider as well.

Investors interested in buying tech stocks should take their time when considering their options. Before investing, be sure to fully understand the business model of the company you're interested in, its industry, and its biggest risks. In addition, it's worthwhile to value the stock in relation to its underlying fundamentals, such as earnings and sales, and then compare those metrics to those of industry peers. After all, even the greatest companies can be overpaid for if they are bought at too high a price relative to their underlying prospects.

CATEGORY

1. Investing
2. Tech Stocks

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