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Commentary

EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF INTERNET SPECULATORS

I AM A TECHNOLOGY NEANDERTHAL

As a bank analyst – and a “laggard,” in marketing parlance, with respect to technology – I’m probably uniquely unqualified to even attempt to say anything intelligent about what’s been going on with internet stocks over the last year. Nevertheless, as I’m probably unqualified to do a lot of other things that I do anyway, I’ve decided not to let my lack of knowledge about technology and the internet get in the way of throwing in my two cents on the subject.

Clearly, the internet sector isn’t the only sector of the stock market that’s in the throes of a speculative frenzy of heretofore unimaginable proportions. What started out as a general technology feeding frenzy early last year has in recent months spread to telecommunications, biotechnology, fuel cell, and, most recently, low-priced bulletin board stocks. If a company is short on fundamentals and long on fantasy, chances are its stock has run up in recent months – in hundreds of cases, several-fold. I’ve chosen to comment on the internet stocks, in particular, as opposed to some of these other equally overvalued sectors, simply because I know even less about the other sectors than I know about the internet.

Those of you who regularly read my research know that I rarely stray too far from straight banking and related issues. However, the run-up in technology stocks, in general, and internet stocks, in particular, over the last year has been such a sizable distraction to our ability to provide guidance on bank stocks, that I felt compelled to make some sort of commentary on the complete and total insanity that appears to be running amok in these sectors day after excruciating day.

This is a nontraditional research piece in two respects. First, as I just pointed out, the topic of this piece is internet stocks (and to a lesser extent tech stocks in general), about which I claim to have no particular expertise. Second, I not only provide my own observations in this report, but also observations made by a several others (duly referenced, of course). I’ve read some clever commentary regarding the tech sector over the last several months – different portions of which some of you may already be familiar – and I decided to include some the more astute observations in this research piece.

The goal of this piece is to put the internet valuations into the appropriately distorted perspective in which they currently reside. I know that a lot of people will say that I just “don’t get it,” but humor me, I’m young and stupid...

THE BIGGEST HURDLE: BASIC MATHEMATICS

“To suppose that the value of a common stock is determined purely by a corporation’s earnings discounted by the relevant interest rate and adjusted for the marginal tax rate is to forget that people have burned witches, gone to war on a whim, risen to the defense of Joseph Stalin, and believed Orson Welles when he told them over the radio that the Martians had landed... Like war, speculation is a social activity. It is carried on by groups.”

- James Grant, *Minding Mister Market* (1993)

In my opinion, the biggest obstacle to making the argument that the internet sector is properly valued – or undervalued, God forbid – is math; it just doesn't work. Before even considering the myriad weaknesses of various business models and the nature of the competitive process, the mathematics underlying the internet sector's current valuation bode poorly, to say the least, for returns on these stocks going forward.

To see what kind of extraordinary future is imputed to the internet sector's current valuation, let's do what many of us do best: make a couple of simplifying assumptions. For my purposes here, I'll use a 15-year time horizon. First, let's assume that those currently investing in internet stocks are assuming that they will get a 20% annual rate of return from holding these stocks over the next 15 years. The number is probably higher – they've returned a few hundred percent over the last two years, after all – but for purposes of conservatism we'll stick with 20% per year. Second, let's assume that GDP grows by an unbelievable rate of 7% per year in nominal terms over the period (that's 4.5% real growth, plus 2.5% inflation – truly incredible, I think you'll agree).

It currently looks as though GDP is going to come in at approximately \$9 trillion for 1999. Therefore, using our 7% annual growth assumption yields a GDP target of roughly \$25 trillion for 2015.

In comparison, the value of all publicly-traded internet stocks was approximately \$1.1 trillion at year-end 1999. Therefore, applying our 20% annual return assumption to the internet sector yields a market value target for the sector of almost \$17 trillion in 2015. Folks, that's almost 70% of GDP. Does anyone see a problem here? The entire stock market, after all, is currently worth a bit over 170% of GDP.

But let's add further perspective to these numbers. A key question is: What percentage of all publicly-traded internet companies that we are likely to see over the next several years have already gone public? I think that most technology experts would say a pretty small percentage, maybe 5%-10%. We are, after all, at the very beginning of the internet investment cycle. To be conservative, let's assume that 20% of all publicly-traded internet companies that are likely to go public over the next several years have already gone public, and let's apply the same return expectations to this group of future companies that we applied to the current crop of internet stocks – 20% annual returns. In this case, the implication is that the internet sector alone will have a market value of some 200%-300% of GDP 15 years down the road. Clearly, this defies all reason by a considerable margin. Once again, the entire stock market is currently worth about 170% of GDP. Historically, the stock market has traded at roughly 50% of GDP. So, is it really realistic to believe that the internet sector *alone* is going to one day be worth 200%-300% of GDP? C'mon.

But the absurdity doesn't end there. For a little perspective, let's compare the current valuation level of the internet sector, in aggregate, to Microsoft in its nascent beginnings. As of February 17, 2000, Microsoft was trading at \$95 per share, or 68x 1999 EPS and 24x 1999 revenues. As a result of Microsoft's incredible success, investors now realize that the company's stock has been undervalued for most of its existence as a publicly-traded entity. More specifically, if we discount Microsoft's stock price of \$95 by 30% per year for 15 years, we find that the "proper" risk-adjusted value – with perfect hindsight, of course – for the Company's stock was roughly \$1.86 per share (split-adjusted) at year-end 1985, compared to an actual trading value of less than \$0.25 per share. That is, with perfect hindsight, we can see that Microsoft's stock was dramatically undervalued in 1985 because it subsequently provided investors with a higher risk-adjusted return over the following 15 years than the market as a whole. (I used a 30% capitalization rate to discount Microsoft's price back to 1985 because the S&P 500 returned roughly 20% per year for the 1985-1999 period, and Microsoft's stock was approximately 50% more volatile than the market as a whole over the period on average.)

Thus, the "proper" Price/Revenue for Microsoft's stock at year-end 1985 was approximately 30x revenue, in contrast to the 5x revenue at which the company traded, on average, during 1985. Now, 30x revenue is a *huge* multiple. For purposes of comparison, the Price/Revenue for the S&P 500 in aggregate was 2.5x at year-end 1999. So, 30x revenues is a big, big number.

But as big as the 30x revenue number is for Microsoft, it pales in comparison with the levels witnessed in the internet sector. In fact, the average Price/Revenue multiple for the roughly 300 publicly-traded internet companies at the end of 1999 was well over 100x – a truly staggering number, to be sure. (*Barron's* Alan Abelson refers to tech valuations at "P/F," or Price/Fantasy, multiples.)

Now, let's think about this for a moment. The market is forward-looking, so it is telling us that the internet sector has a very bright future. But exactly how bright, in my opinion, is truly amazing and, in fact, unprecedented (and, for that matter, utterly ridiculous). What the market is saying is that the current crop of publicly-traded internet stocks, in aggregate, is going to achieve a level of success over the next 15 years that is a *multiple* of the success that Microsoft, as an individual company, has

achieved over the last 15 years. That is, the current crop of internet stocks – mostly money-losing companies with untested business models, operating in highly-competitive businesses, with young, unseasoned managements – are, in aggregate, going to financially outperform – that is, *considerably* outperform – over the next 15 years arguably the most successful 15-year run of any technology company in the history of our financial markets.

Think about it: Microsoft has had a dominant market position (some might even say monopoly), in a rapidly growing industry, in a business (software) that traditionally sports huge profit margins and returns on invested capital. In other words, Microsoft is in a *great* business, and its profitability is testament to this fact: an operating margin of over 50% and a return on capital of over 25% during 1999.

Internet companies are, on the other hand, for the most part in a *bad* business: no barriers to entry and extremely competitive business conditions, both of which tend to engender slim profit margins and low returns on invested capital. Despite these facts, however, the market is telling us that the publicly-traded internet companies, in aggregate, are going to achieve over the next 15 years a *multiple* of the financial success that Microsoft has achieved since 1985. Well, guess what? This is not going to happen. In fact, it's not going to come even close to happening.

To my way of thinking, the fundamental problem with the technology sector, and the internet sector, in particular, is that there are hundreds of companies that are required to grow earnings – earnings, not merely revenues, mind you – by rates of 40%-50% and greater for twenty years and more in order to justify their current market valuations. Very few of these companies will achieve such growth; ergo, hundreds of companies' market values are at some point going to decline precipitously from current levels. And, in my view, diversification isn't going to help much here. The small number of winners, after all, are for the most part already priced to be winners. But the numerous inevitable losers are also priced to be winners and thus have steep declines ahead of them. Consequently, so many stocks are so irrationally priced that I don't see diversification adding much benefit under current circumstances.

"It doesn't make any sense to me at all," says MIT economist Kenneth French, himself an ardent proponent of the efficient market hypothesis. "These internet valuations fly in the face of everything I've ever believed." ¹ Join the club.

GROWTH ≠ ECONOMIC PROFITS

Clearly, it is the belief of many investors that the internet is a "transformational" (I don't think this is a real word, but you know what I mean) industry, representing a paradigm shift in both business and the way we as humans live and communicate with each other. Certainly, such an industry's stocks will grow into their valuations over time as a result of the sheer size and exponential expansion of demand for these company's services, right? Doubtful.

Unfortunately for internet investors, there have been many industries that have, on the one hand, transformed our world and, on the other hand, provided investors with meager returns over the long term. The list includes the automobile, aviation, television/radio, railroad and appliance industries, to name a few.

Take automobiles, for example. At the peak of investors' fixation with the promise of the auto industry, there were over 200 car manufacturers. Anyone who could've foreseen the incalculable impact that automobiles would have on our way of life probably would have come to conclusion that investing in the auto industry was as sure a goldmine as one would ever find. ²

So, what were the results in hindsight? After years of brutal competition, we're down to three domestic auto makers, none of which have been particularly stellar performers over the long term. And, as you might imagine, most of the other 200-plus manufacturers were not bought out by the survivors over time – they went out of business. Competition ultimately proved to be too great for most of these companies to overcome. ³

So, in the auto manufacturers you have an industry that literally transformed our nation in a considerable manner, yet investors in the sector were treated to relatively poor results over the long term. Industry-wide growth did not, for the most part, materialize into economic profits for the industry's investors.

Another transforming invention of the 20th century was the airplane. Any investor who was around at the airline industry's nascent beginnings must have been justifiably excited about the airplane's unlimited possibilities. But it wasn't to be. Warren Buffett recently recounted to *Fortune* that there were about 300 aircraft manufacturers in the 1919-1939 period. How many of them are still with us today? But a handful. ⁴

Where airlines are concerned, the picture isn't much prettier. In fact, almost 130 airlines have filed for bankruptcy since 1980. Buffett noted in Berkshire Hathaway's 1993 annual report that as of 1992, the cumulative profits earned by this country's airlines since the dawn of aviation was approximately zero. That's right, despite the enormous growth of airline traffic over the last 80 years, the cumulative profits of the industry added up to *nil* as of 1992. Clearly, the airlines have had good fortune since 1992, but seven years of prosperity don't make much of a dent on the poor returns investors received on their airline investments over the previous decades. As in the case of automobiles, incredible growth in demand for air travel did not translate into economic profits for the industry's investors over the long term.⁵

There are many other industries that have had an enormous impact on our lives – the manufacture of radios, televisions, and appliances, for example – that have had an equally enormous impact, of the negative variety, on investor returns in those industries. But, at this point, I think you get the idea: *An industry's growth rate – that is, the growth in demand for an industry's products and services – does not necessarily correlate with the profitability of the industry's participants or the returns that investors will capture as a result of investing in such companies.*

Internet investors, of course, will scoff at these analogies, countering that the dawn of the internet is bigger than the dawn of autos, railroads, aviation, radios, televisions, etc. Maybe it is equal to, or perhaps bigger, than any *one or two* of these industries. But is it bigger than *all* of them, in *combination*? Is the evolution of the internet, on its own, going to change our lives going forward in a manner that is greater than the *combined* impact that our society has felt from the evolution of the auto, aviation, radio/television, and home appliance industries? To quote Howard Stern, "Puhhhleease." I'll grant the internet boosters that the internet is going to have a major impact the way we live, but let's keep things in perspective.

The fundamental problem is that there are probably less than 10 or 20 future Microsofts buried in the Nasdaq. But, at current prices, the market, in its infinite wisdom, is predicting there will be hundreds of them. As G. Bennett Stewart, co-founder of financial consulting firm Stern Stewart, says, "There are only a certain number of races to be run, and there can only be a certain number of winners. The market is predicting too many winners. Most likely, the Web will generate huge wealth, but the payoff will flow mostly to consumers in the form of lower prices. With all deference to the 'new paradigm,' that's how markets work."⁶

In his recent interview with *Fortune*, Warren Buffett summed up the dilemma that internet investors will ultimately face as follows: "The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors."⁷ To which the internet crowd will counter, "Buffett, Buffett.... the name rings a bell... is he with Kleiner, Perkins?"

INTERNET ECONOMICS MEET ECONOMICS 101

The single biggest threat to the future profitability of internet companies – and the future returns from internet investments – is a basic one: competition. The biggest problem that I have with most of the internet companies is that they appear to be operating in business environments that are currently, or will be shortly, textbook cases of perfect competition.

As mentioned previously, most internet companies are operating in businesses with very low barriers to entry, and as we all know, success begets competition. And if we reflect back on afternoons spent in Economics 101, we'll remember what happens in highly competitive industries: economic profits trend to zero as competition floods the market. I don't think I have to tell you what sort of multiples companies in the most competitive industries trade at: low ones.

Aside from the unattractive economic prospects of most internet companies, the other big problem I see is a void of management talent. Most of the people running these companies are in their 20s and 30s, have limited business experience, very limited experience in actually running a company, and practically no experience running a rapidly-growing company in an extremely competitive industry. For the most part, we're dealing with neophytes in the management department. Smart neophytes, no doubt, but neophytes nevertheless.

I realize that these companies are run by intelligent people, but here's my question: How many people are there out in tech-land who are really capable of effectively managing a company in a highly-competitive, rapidly-changing industry that is growing at 50%-100% per year? In my view, there aren't that many. Such people don't grow on trees. They are extremely rare, and history is testament to that fact.

Managing a growing company under the best of circumstances is not an easy task. Managing an internet company, with all that it implies, is exponentially more difficult. Yet I see *hundreds* of newly-public internet companies trading at valuations that imply that *all* of their management teams will be up to the task of managing extraordinarily high growth rates for very long periods of time under amazingly difficult and uncertain business conditions. Despite their intelligence, most of these managements will not be up to the task because they are mere mortals, and very few mortals' brains are wired to manage businesses that will face the myriad challenges that all of these internet companies will grapple with over the next several years.

At Berkshire Hathaway's 1999 annual meeting, Warren Buffett (don't worry, this is Warren's last contribution to this piece) discussed the rarity and challenges of growing into a large market capitalization:

"In the whole of the United States – which is, by far, the most prosperous country in the world – there are probably around 400 companies that are earning \$200 million a year after taxes... and you can name a whole bunch of 'em. Of those 400, you can probably name 350.

"Five years from now, instead of 400 being on that list, there'll probably be 450 on that list – maybe 475. And a lot of those companies will be companies that are earning between \$150 million and \$200 million *today*. So there'll probably be 20 – or some number like 20 – that come from nowhere.

"If you look at the number of companies selling today at a price which implies \$200 million or more of earnings right now, you'll find dozens and dozens of such companies in the high-tech arena. A *very* large percentage of those companies aren't going to fulfill people's expectations. And I can't tell you which ones, but I know that there won't be dozens and dozens and dozens of those companies making a couple of hundred million dollars a year. And I know that they're selling at prices that *require* them to be making that much money or more. But it just doesn't happen that often.

"Biotech was all the rage some years back. How many of those companies are making a couple of hundred million dollars a year? It just doesn't *happen*. It's not that easy to make lots of money in a business in a capitalistic society. There are people that are looking at what you're doing every day and trying to figure out a way to do it better, underprice you, bring out a better product or whatever it may be.

"And a *few* companies make it. But here in the U.S., after all of these decades and decades and decades of wonderful economic development, we still only have about 400 companies that have hit the level that would be required of a market cap of \$3 billion [or more]. And yet many companies are [now] getting \$3 billion of market cap virtually the day they come out. You want to think about the math of all this."⁸

I realize that Buffett is an even greater tech neanderthal than myself, but I think that his observations transcend technology and get to the root of the business challenges faced by all firms: Competition in a free market makes it very difficult to generate economic profits (that is, returns on invested capital in excess of a company's cost of capital). While revenue is nice, at the end of the day, only economic profits support stock prices. Valuations in the internet sector do not in any way, shape, or form reflect this reality.

HOW WE GOT HERE

"A crowd is not merely impulsive and mobile. Like a savage, it is not prepared to admit that anything can come between its desire and the realisation of its desire... The notion of impossibility disappears for the individual in a crowd... A crowd scarcely distinguishes between the subjective and the objective. It accepts as real the images evoked in its mind, though they most often have only a very distant relation with the observed fact."

- Gustave Le Bon, *The Crowd*

So, what gave rise to the speculative frenzy that we are now witnessing? In my view, most of what we are witnessing is the result of the investing public's, and especially individual investors', wanton regard for risk. In effect, the investing public has taken on the role of amateur venture capitalists – funding excessively risky ventures several years from profitability at prices hundreds of times higher than professional venture capitalists were willing to fund the same ventures.

With the help of prominent investment banks and their teeming hordes of analysts-for-sale, the professional venture capitalists have happened upon a money machine: Back speculative ventures for a few months, which in previous times would have been backed for *years* until profitability was reached, take the venture public, and hope that they can bail out before the ultimate demise of said venture is evident to the gullible public. Clearly, not all of these ventures will fail, but my guess is that a majority of the internet-related companies taken public will go bankrupt, and virtually all of those that don't fail will provide disappointing investment returns to investors from their current inflated valuations.

This total lack of risk aversion is the result of several factors. The primary factor, however, is that most of today's investors have never experienced a sharp, protracted downturn in equity values. This is a result of our strong domestic economy – as of February, the current economic expansion is the longest in U.S. history – as well as the success of the Federal Reserve Board in “guiding” (for lack of a better word) the economy via interest rate policy.

Unfortunately, the Fed may have been too successful with interest rate policy during this expansion. At each potential turning point in the economy, whether the Mexican Peso Crisis in 1994 or the Asian Contagion in 1998, the Fed took action and made clear to market participants that it was going to do whatever had to be done to avert any negative economic impact on the domestic economy. While such moves were clearly favorable for the U.S. economy in the short run, these actions have, in my opinion, given investors a false sense of security that has, in turn, led to the belief that stock markets will never go down. This belief has, in turn, engendered a risk-taking mindset among individual investors that has led to the tech bubble with which we are now faced.

I'm not blaming the Fed for its previous policies, mind you. I'm merely pointing out the fact that the Fed's previous successes may have sown the seeds of its own destruction. We are now faced with an asset bubble in technology stocks that has to burst at some point, and such a bursting will likely have a negative impact on the overall economy when it eventually comes to fruition.

Has the Fed made a mistake by not pricking this bubble sooner, before it began affecting the economy under the guise of the “wealth effect”? Perhaps. Certainly, lots of smart people think this is the case. But, frankly, it's beyond the scope of discussion here.

Nevertheless, suffice it to say that we are witnessing an asset bubble in internet, technology, biotech and, to a lesser extent, telecommunications stocks brought on by a speculative mania that is unprecedented in magnitude in the history of the world's stock markets. We see multitudes of stocks make parabolic moves on a daily basis that would, in previous times, have been unusual to see from more than one or two stocks per week. In an all-out assault on financial logic, the tech stocks have continued to soar even as long-term interest rates have soared since the summer of 1999. Thus, interest rates appear to have no effect on these stocks, which are the longest duration assets on the planet and, as such, should be the most sensitive to rate swings.

In the meantime, real companies with real earnings – the so-called “Old Economy” stocks – languish at single-digit earnings multiples as investors chase stocks of the “New Economy.” The current investment mantra seems to be, “Why own companies with *definable* operating prospects – and, thus, definable (i.e., less than 25% per year) returns – when I can own companies with *undefinable* operating prospects and unimaginable return potential?”

Why, indeed? The companies with definable operating prospects, after all, are valued using traditional tools of fundamental analysis – earnings, cashflow and balance sheets matter. The New Economy companies, on the other hand, sport valuations that have no mooring to any underlying fundamentals. Nothing matters. It's the greater fool theory writ large – buy high, sell higher. Using this line of thinking, there are hundreds of New Economy companies that are worth infinite amounts of money. They aren't *really* worth infinite amounts of money, of course. But, there's no way to prove beyond any shadow of a doubt that any individual company *isn't* worth its absurd valuation until *after* the business has failed.

Boring reality rules the Old Economy stocks. Hopes, dreams, and fantasy fuel the New Economy stocks. (When Oscar Wilde described a cynic as “a man who knows the price of everything and the value of nothing,” he had no idea how aptly he was describing speculators of the new millenium.) If you expect to compound your money at 50% per year, only the road paved with hopes and dreams will get you there, because the real world doesn't work that way. Clearly, those trying to take the high road in investing these days aren't encountering much traffic.

To give you some idea of the manic behavior of the participants in this greatest-of-all-manias, I provide below a tiny sample of anecdotes from William Fleckenstein's “Mania Chronicles” section – selected emails sent to Mr. Fleckenstein by his readers – of his daily column “The Contrarian” (www.siliconinvestor.com/insight/contrarian). I have an affinity for Mr. Fleckenstein's

views, not only because they are well-founded and iconoclastic, but also because they are delivered with a measure of verve and wit that is rare in financial journalism. Who else refers to CNBC as "Bubblevision," market commentator Maria Bartiromo as "the Queen bingo caller," and Wall Street analysts as "Dead Fish?" While the following incidents are anecdotal I think that they are representative of what's going on throughout the country based on the conversations that I have with friends, investors, and market participants on a daily basis:

"We went to our local bank yesterday to transact some business, and spent some time chatting with the branch manager. She does not know what business we are in, so when we asked her if she'd seen any increase in personal loans she replied out of hand that indeed she had. Indeed, the personal loan demand at her branch had escalated rather substantively. She then proffered that the sole reason for the sharp rise in personal loans was investment in the stock market. She said that doctors, lawyers, farmers, auto dealers... all of the leading figures of the local economy (and their wives) had been in recently to borrow money to '*put into the market.*' We asked her how long this had been going on, and she said that the branch had been making personal, signature loans like that for some while, but that the demand had really escalated in the past several months and has really become 'hot' in the past several weeks. She wondered if it was too late for her to join in the market's enthusiasm! We said, 'We don't know,' and left bemused and afraid."⁹

"In potentially one of the greatest anecdotes of the period we're living in, a story passed on Bloomberg this morning about a gold mining company trying to morph into an internet company. As one of my friends pointed out, you can't make this stuff up. This is from Bloomberg: 'South Sea Natural Resources surged on optimism. A group of investors led by Marcos-era Cabinet Minister Roberto Ongpin will take over the money-losing gold miner and turn it into an internet company.' (Note the company's name, harking back to a speculative bubble from yestercenury!)"¹⁰

"This bubblehead [I work with] bought some stock in a dog biomedical company that has never earned a thin penny in its life. (They should be working on a longevity drug so shareholders might live long enough to see a profit.) At \$14 a share, nothing but a risky drug called Campath in the pipeline, and -\$3.50 in per share earnings, I told her I would walk away. The stock then zooms in one month (for no real reason) to over \$30 per share and I have to listen to this bubblehead tell me what an idiot I am every day. Now she has applied for a mortgage on her home and has taken cash advances from two Visa cards to buy – you guessed it – even more of the stock!! Her plan is to have the house paid in full within the next couple of years."¹¹

"The small town in which I live has an ancient but beautiful city hall. The elevators in this building are still run by elevator operators, and the other day an elderly man working in this capacity smiled broadly and suggested that I buy Juniper Networks. He'd 'made a bundle' and had no interest in ever selling. Ever. Instantly, I was struck by the irony of this situation as it related to 1929, though it over and called my broker. I'm now 100% in cash."¹²

"Recently, I was on vacation in rural New Mexico. I stopped into a Native American Indian store in the middle of nowhere, hoping to buy a souvenir. The place was nothing more than a roadside shack. Inside the place was an elderly Native American woman, almost nothing else except for one item: a brand new color television, which via the outside satellite dish was tuned to CNBC. I asked the woman if she invested, and she smiled broadly and showed me a large packet of mutual fund and brokerage statements. She told me that she used to drive two hours each Friday night to a tribal casino, but now she was more interested in the stock market."¹³

"Yesterday I was coming home from lunch and I was stopped by the Jacksonville sheriff's office. When asked why I was speeding, I exclaimed that I was late getting back to the office before the market closes. (As a fund manager, I have to be there.) He then exclaimed, as he was writing a ticket, that he and his buddies were 'trading' some penny stocks and making a killing. I asked, as if I needed to, how/what they were doing? He replied they were buying 40 and 50 thousand shares of 1 and 2 cent stocks and getting ¼ and ½ point trades – and 'making a killing!' He went on to further explain that the risk was so minimal considering the returns available."¹⁴

"A family friend of ours, who is a mid-level insurance salesman, just informed us that he is quitting his job of 11 years. He is 41 years old, married, with three kids. He told us he is preparing to move his family from here in Ohio to a tiny town high in the Rocky Mountains, where his new job will be as a day trader. That will be his only way to pay the bills. He's armed with about \$100,000 in life savings, a laptop computer, and

an online discount brokerage account. Apparently, he says he was motivated by a late-night 'trade your way to riches' infomercial, which convinced him he could move to the mountains, trade by day, and live the life he's always wanted. He made his first foray into the stock market a few weeks ago, when he bought a stock at 50 cents and sold it the next day at \$3. He said he gave notice at his job the next day."¹⁵

"I've got a near-client that has very successfully run a business for the past 10 years and has become fairly wealthy. He asked me what I do and I told him I like sure things like cash takeovers with room. I told him about them and he said he wanted that type of investment. We sent him the paperwork for an account. In the week and a half it took to get his paperwork back and the account opened, he started buying high-techs at another firm. I talked to him last Thursday and he told me about the \$3 stocks he sold for \$4.50. The \$15 stock he sold for \$22. Everything is 'e' this and dot-com that... This guy had all his money in government bonds up until January, and now he wants high-tech funds!? Then he said the ultimate to me: 'I've learned a lot over the past month. I've really got the hang of this stock trading stuff already. I really know what I'm doing. I've already made more in one month more than I made on all my money in the bank last year!' I told him I was still buying my boring takeovers. He wasn't interested. 15 percent isn't good enough anymore. He's swinging for the fences now. He wanted a 'real mover.' He told me I didn't know what I was doing and I was out of touch. I had to get where the action was. That's great. One month of experience and he is the expert and 15 years' experience is worthless."¹⁶

I could go on and on and on with hundreds more stories like this, but what point would it serve? You get the picture. Clearly, the world has gone mad. The speculative mania surrounding tech stocks has reached every nook and cranny of our society. And, unfortunately, it will likely take a complete collapse in technology shares to equilibrate the current imbalances.

INTERNET M&A: AT WHAT PRICE VALUE?

Before I leave the valuation issue completely, I must relate a story I heard first-hand regarding a recent acquisition made by a prominent internet company. I have changed the names to protect the guilty.

Company S(eller), an old line firm in its industry, had recently inked a marketing agreement with Very Prominent Internet Company (henceforth, "VPI Co."). As the deal was likely to boost S's bottom line to some degree, the company decided it might be a good time to go public. So, Company S hired an investment banker who informed the owners that the value of the company would likely be around \$80-\$90 million post-IPO, or around 27x-30x the previous year's after-tax profits.

VPI Co. got wind of S's plans, called S's president, and informed him of VPI's interest in acquiring VPI outright. S's president, of course, asked what VPI might be willing to pay for S. In the same phone call, prior to any due diligence whatsoever, VPI suggested that it might be willing to pay as much as \$160 million for S. (Note: VPI had no idea of what S's market value was to be in the proposed IPO.) Justifiably astonished, but in a composed manner, S's president informed VPI that he would have to check with his partners to see if this offer interested them.

As one might expect, such a deal did interest them, but there was a concern regarding the volatility of VPI's stock, the currency to be used in the transaction. In the meantime, another prominent internet company expressed interest in S, and S went to meet with the management of this company to explore their level of interest. VPI, however, got wind of the interest from the other party and, worried, made an offer of \$260 million to S's president. And so the deal was done.

So, there you have it. A company that was worth \$80-\$90 million in the real, cash world became, in very short order, worth three times that amount in the unreal, internet money world. But, even more shocking than the valuation, in my opinion, was the total lack of due diligence used in the transaction. If this is representative of most M&A transactions in the internet world – and I suspect that it is – I weep for the future of these companies.

At the end of the day, virtually all transactions taking place in the internet arena are happening as a result of the use of artificially cheap capital – the acquirer's dramatically inflated stock price. The problem, of course, is that all reflexive processes, such as the one we are currently witnessing, must come to an end – they always have and they always will. It may be sooner, it may be later, but eventually these reflexive processes exhaust themselves, and the unwinding is very unpleasant.

THERE ARE NO "FREE LUNCHES"

Modern Financial Theory tells us that there are no "free lunches" available in the capital markets. That is, there are no easily identifiable methods of generating excess risk-adjusted profits.

Clearly, the current environment for tech stocks suggests otherwise. After all, it appears that any schmoe with a computer and an on-line trading account can double his/her money every few weeks. The reality is, of course, that it just ain't so. These speculative stocks don't retreat to single digits at the closing of every trading day. Therefore, most of the speculators are not, for the most part, taking their money off the table at the end of each trading day. On the contrary, most of these gamblers are re-leveraging any paper gains that they have in these stocks. That's why margin debt has increased by over 200% over the last three months even as the Nasdaq has soared. Ultimately, of course, such re-leveraging will exacerbate the inevitable decline in the tech sector.

In these days of reckless speculation, we are trying to stay focused on the long-term realities of capital markets and human endeavor. One enduring theme is that a company's stock price cannot outperform its underlying fundamentals forever. While stocks will wax and wane above and below intrinsic value for long periods of time, they inevitably cross their intrinsic values over a period of years. In a like manner, very few individuals can financially outperform their own fundamentals (intelligence, education, knowledge, experience, work ethic, etc.) over long periods of time. A small number get very lucky, but most people's fortunes – or lack thereof – track their personal fundamentals, or "accumulated human capital," over the long haul.

Aside from any issues that we have regarding the (ridiculously high) fundamental valuations assigned to certain companies, one of the clearest indicators that we have telling us that the speculative sectors of the stock market – tech, internet, biotech, telecom, penny stocks, you name it – are at a peak is that too many people with average amounts of human capital are making too much money. Whether we're talking about recent IT graduates making millions from stock options at internet start-ups, young MBAs making millions as technology investment bankers, or mechanics making a few thousand dollars a week day trading penny stocks, the principle remains the same: When the dust settles, few individuals can financially outperform their fundamentals over the long term. It is no coincidence that a majority of lottery winners inevitably file for bankruptcy, as those who win the lottery are generally the least fit to manage the resulting windfall. Just as lottery winners have a difficult time outperforming their human capital, John Q. Public will have a difficult time holding onto the paper profits that he's generated in the most speculative sectors of the stock market. It is our deepest conviction that the vast majority of the "easy" wealth that's been accumulated in the current speculative mania will disappear. (I say "accumulated" rather than "made" because you have to sell, and not lose everything in the ultimate collapse, to have really "made" any money in this market/casino.) With hindsight, investors will one day (soon) realize that such wealth wasn't "easy" to accumulate after all; rather, it was temporary.

Contrary to popular belief, there are few free lunches in the capital markets. Ergo, the free lunches that appear to have been served up over the last year will ultimately be followed by rather high accumulated bills, in conjunction with a rather nasty case of indigestion. We only hope that innocent bystanders aren't forced to pay part of the tab when it inevitably comes due. But, if history is any judge, everyone will suffer in some manner, wide-eyed innocent and rabid speculator alike.

WHAT ALL THIS MEANS FOR BANK STOCKS

I think tech stocks, and more specifically, internet stocks, are going to cave in at some point in the near future, probably before the end of this year. So, what does this mean for bank stocks?

As I've stated previously, I don't think that bank stocks can make a meaningful, lasting recovery until the tech stocks have corrected. Until the tech sector becomes less attractive – that is, until tech investors have suffered some near-fatal injuries – money will continue to flow out of Old Economy stocks and value-oriented mutual funds and into New Economy stocks and growth mutual funds. Until the performance dissipates, money will continue to chase it in the tech sector.

This is not to say that we can't have a transient rally in bank stocks prior to any tech implosion. After all, the sector is so oversold and illiquid at this point that it would take very little buying interest to push the bank stocks up. Nevertheless, despite the banks' attractiveness from a long-term perspective, the fundamental short-term outlook for banks doesn't augur well for near-term price performance.

My guess is that when the techs do correct, everything, including bank stocks, will go down with them, although the techs will likely decline by several times the magnitude of everything else. Once the dust has settled, and assuming that the incorrigible

investing public isn't so leveraged prior to the meltdown that we're catapulted into recession, investment money will begin to flow rationally into value situations, as it has in the past. Whether this process will take days, weeks, or months, I have no idea. I would think that a lot of investors will wait on the sidelines to see what effect, if any, the tech wreck will have on the real economy before aggressively reallocating capital. But, the reality is that no one really knows what the aftermath of the tech meltdown will look like.

A big question, to which I don't have a good answer, is: What impact will a tech wreck have on the real economy? The Fed estimates that the wealth effect has been adding about 1% per year to GDP growth since 1995. If this is accurate, and if investors are rational, then a tech meltdown shouldn't have a fatal impact on our economy. After all, shaving 1% off of a 3%-4% growth rate is no big deal going forward. If, however, the Fed has underestimated the wealth effect, a tech wreck could send us into the throes of a recession. Clearly, this would be quite bad for bank stocks, despite the trashing they've taken recently.

I am in the camp that believes a correction in tech stocks will slow the economy, but will not lead us into a recession. Although, admittedly, I have no objective basis for this opinion – I'm merely an optimist.

The worst case scenario for bank stocks is as follows. Tech stocks crash in a year. Consumer confidence falls as heavily-leveraged investors go belly-up. We fall into a recession and bank fundamentals deteriorate as loan losses mount. Bank stocks fall another 20%-30% and there's no daylight for three years or so.

The best scenario for bank stocks would be the following. Tech stocks crash soon (I think there's 60% downside on the Nasdaq from current levels). The Fed, worried about the crash's ultimate effect on the economy, stops raising interest rates. The economy slows to a 2%-3% annual growth rate, and the Old Economy stocks, including banks, rally bigtime as some semblance of balance and order is restored to the various sectors of the stock market.

Obviously, I have no idea how all of this is going to play out. But I do know a couple of things. First, while the internet may be revolutionary, the valuation of the sector's stocks is no different than many of the fads that we've seen in the past. The internet will change the way we live and conduct business, but it is unlikely that investors will realize high investment returns from holding these stocks over the long term. In fact, from current valuation levels, I think that the majority of internet stocks are 60%-80% overvalued. Second, if we are not headed into an imminent recession, bank stocks will outperform the overall market dramatically over the next few years from current valuation levels.

Hopefully, the following words from Horace will ultimately play themselves out in the stock market: "Many shall be restored that are fallen, and many shall fall that are now in honor." But, I'm not holding my breath.

David B. Moore