The Internet Contrarian

APRIL 22, 1999

Monday, April 19, 1999 was not a banner day for Internet stocks. They took their biggest one-day hit ever, with the Dow Jones Internet Index plunging nearly 19%. Over the next several days, most of them bounced back almost to the levels from which they fell, leading many to believe that Monday was just a one-day event.

If you are a big investor in Internet issues, use April 19th as your wake up call and run, don't walk, to the exit. For while the Internet stocks may make a short-term come back, current Internet stock prices make absolutely no sense. No other market mania has ever produced such outlandish valuations, and I believe that when the inevitable fall comes, it will be harder and faster than anything we've ever witnessed.

Don't get me wrong. I'm wildly bullish about how good the Internet will be for consumers. But I'm incredibly bearish about the prospects about the ongoing profitability of the most of the current high-flying web businesses. It seems to me that the only successful business model found to date is to create a web company, do an IPO and get rich quick selling your shares to gullible investors.

The Go-Go Years: Can You Say Mellow?

I just finished reading The Go-Go Years: The Drama and Crashing Finale of Wall Street's Bullish 60s by John Brooks. It's a beautifully written book about the folly of market speculators in the 1960s and early 1970s--the last market mania to even approach the frenzy of today's Internet craze. After finishing it, I find myself agreeing with Michael Lewis, who wrote the book's new forward. Lewis points out how tame the stories in The Go-Go Years seem in light of today's Internet mania. Back in the 60's, investors were pricing stocks like Polaroid, Avon, and IBM at nearly 100 times earnings. 100 times earnings? That's practically a value stock in today's fantasy-driven market that has priced AOL at 635 times earnings and Amazon.com at 43 times sales.

The Leader of the Pack

We are currently witnessing the biggest bubble the stock market has ever created. When the Internet insanity ends, truckloads of books will be turned out; endless comparisons to Dutch Tulip bulbs and Ponzi schemes will be made; and a whole generation of ex-day-traders will rue the day they were seduced by the siren song of the Internet. This mania is a creation of fantasy and ludicrous expectations and of the childlike notion that hope can prevail over experience. Legions of inexperienced people--many of whom can't even begin to understand a balance sheet--believe that all they need do to secure their fortune is to plunk down their money on Anything.com and watch the profits roll in.

For the patient, educated, long-term investor who knows that over time the market is bound by the rules of economics, the last year and a half has been pretty sickening. No doubt small fortunes have been made by speculators willing to pay the moon for a great story, regardless of underlying values. Even April 19th's wake-up call may fall on deaf ears, as many big Internet speculators continue to believe their own hype.

Let's take a look at two Internet Mania Poster Children, Amazon.com and America Online. I was an early user of both, and I believe they've each created a great brand. But if I'm a good example, many of their current users will eventually move on, finding cheaper and better sites offering the same level of service.

Amazon.com: A Wobbly Model

A great company is not always a great investment. Take Amazon.com. It has a market-cap greater than the dollar value of all the books sold in this country, yet the company has never made money and boasts a negative profit margin of 20.4%. And more of the same is forecasted for years into the future!

I love Amazon's website, yet recently discovered that it's cheaper for me to buy the paperback version of my book How to Retire Rich at my local Barnes & Noble or Borders! At Amazon, with the shipping and handling, I've got to shell out $14.35 for a $13.00 book. Even after 6% state sales tax, I'm still better off at my local bookstore than Amazon.

So, what about other books, like What Works on Wall Street or Tom Wolfe's A Man in Full? For What Works, Amazon saves me eight cents off the list price (after shipping), but almost $5.00 for A Man in Full. Looks good, I'll buy, right? Wrong. Unlike a regular store, where I'm physically present and disinclined to run all over town looking for a better bargain, I have no such limitations on the web. In Cyberspace, there is no salesperson to feel indebted to--just a better bargain to be found.

In Cyberspace, I don't feel indebted to any salesperson or shop owner: I'm just looking for the best deal. In Cyberspace, I'll take a minute and pop over to Bestbookbuys.com, where I find that I can buy A Man in Full from Booksamillion.com for $19.58--about $5.00 less than Amazon.com charges. And since I can buy the book in the same amount of time--you know where I'll buy it.

Amazon's business model depends upon their ability to charge premium prices for commodity products like books, CDs and pharmaceuticals, just because people like the shopping experience at Amazon. But the rub is that in cyberspace, the experience is pretty much the same no matter where you buy your commodity product. Like my friend Dave Chilton, author of The Wealthy Barber, says, "when I go to a fine restaurant to enjoy the ambience, the deal is that I've got to eat their food. The same is not true on the Internet. I can go to Amazon, read the reviews and make maximum use of their site's ambience, than in ten seconds click over to www.acses.com or www.bestbookbuys.com and find the lowest price, which is almost never from Amazon."

And what's going to happen when a bricks and mortar company like WalMart--with real earnings and sustainable margins--decides to get into the game? What if they finally find a business model that shows it can turn a profit on the web, and they put up a site called Bestprice.com, guaranteeing everything sold there will have the lowest price anywhere, or double your money back? Imagine convenience married to price, all backed by a well-known company with a real operating history. Amazon.com may be a great story now--but I think a few years from now the story of the rise and fall of its price will be even more riveting.

One-Sixth of the World's Population? No Problem!

Even when Internet companies have real earnings, the dot com mania is sending valuations into the stratosphere. America Online trades at 635 time trailing earnings, yet has a negative Economic Value Added (EVA) of 10.3%. That means that investors are betting its entire $130 billion market-cap depends on future growth. To just maintain current valuations, AOL will have to get one-sixth of the world's population to pay full price for its service, and do that every year!

Jeremy Siegel points out in the Wall Street Journal: "AOL is currently selling at more than 700 times its earnings for the past 12 months and 450 times its expected 1999 earnings. These are unprecedented valuations for a firm with this market value.... If AOL in its "maturity" sports a PE ratio of 30--and this is a ratio that still anticipates substantial growth--it will have to generate

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net profits of about $6.7 billion per year to maintain a $200 billion market value. In 1998 General Electric was the only American firm with profits that high."

And the beat goes on. A well-known financial publication just ran a story about how Yahoo! might be better off if they never had earnings. Respected analysts say the biggest risk with Amazon.com is not owning its shares.

Price-to-What?

But these crazy Internet stock valuations don't seem to bother the new-era day-traders. I doubt many of them know what a price-to-sales ratio is, much less than that AOL's is dangerously high at 40. To them, all that matters is where the price is moving this second. It's comic and sad.

This same group of people recently sent a stock's price soaring because of a mistaken ticker symbol. PBS's Nightly Business Report ran a story on a company called Intasys, but mistakenly gave the ticker symbol for a company called Interface Systems. The next day Interface Systems doubled in price because a whole herd of people bought it based on nothing more than seeing the ticker symbol on TV.

The Dismal Science Foretells the Mania's Dismal End

Near the top of any mania, you'll see often see outright stupidity rewarded. The current myopia cannot and will not last. After every other market mania--from tulip bulbs in 17th century Holland, to radio stocks in the 1920s, to Aluminum stocks in the 50s, to computer stocks in the mid 1980s and the biotech craze of the early 1990s--those boring laws of economics always rear their very sane heads. Ultimately, a stock's price must be tied to the future cash payments a company will make to you as an owner. History shows us that the more you pay for each dollar of a company's revenue, the lower your total return. It does this because it has to--that's why economics is called "the dismal science."

Because the numbers ultimately have to make sense, the majority of all currently public Internet companies are predestined to the ash heap of history. And even if we could see the future and identify the ultimate winner in e-commerce, at today's valuations it is probably already over-priced. When people realize that the mania has dried up, and that "the greater fool" isn't there anymore, they'll all rush for the exits at the same time. And the same thing that drove Internet prices up--lack of liquidity married to irrational investors--will drive them down, only more quickly.

Consumers Win

The biggest Internet winners will not be day-traders, but consumers. The ultimate irony here is that I think the Internet will revolutionize the way we shop, communicate and gather information. It will no doubt transform society in much the same way earlier innovations like radio and television did.

But until some clever person figures out how to make a profit on the Web, the thing to be euphoric about is all the money we save buying things from companies that can never make a profit.

Investors should keep in mind that there is no certainty that any investment or strategy will be profitable or successful in achieving investment objectives. Past performance is not an indication of future results.

This commentary was written by Jim O'Shaughnessy while he was the Chairman and Chief Executive Officer at O'Shaughnessy Capital Management.

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